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CURRENT FINANCIAL CONDITION OF THE FARM CREDIT SYSTEM

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

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CURRENT FINANCIAL CONDITION OF THE FARM CREDIT SYSTEM

WEDNESDAY, SEPTEMBER 17, 1986

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 10:35 a.m., in room SR-332, Russell Senate Office Building, Hon. Jesse Helms (chairman of the committee) presiding.

Present: Senators Helms, Cochran, Boschwitz, Hawkins, Zorinsky, Leahy, Melcher, Dixon, and Harkin.

STATEMENT OF HON. JESSE HELMS, A U.S. SENATOR FROM NORTH CAROLINA

The CHAIRMAN. The committee will come to order.

The purpose of our hearing this morning is very important. It is to examine the financial condition of the Farm Credit System.

Just about a year ago, this committee held a similar hearing, and that began the process which led to enactment of what is known as the Farm Credit Act Amendments of 1985.

That emergency legislation was passed in response to a critical situation in the Farm Credit System, allowing changes that were necessary to insure the continued ability of the System to provide farmers a stable source of affordable credit.

A key part of the bill was an authorization for Federal assistance, if an infusion of capital proves necessary, to keep the System institution's financially viable.

So, that brings us to this morning, all of us hope that we can learn precisely what steps the System and its institutions have taken to restructure itself, and how those steps have affected the financial condition of the System, and its ability to service borrowers.

Now, despite the self-help changes that have taken place in the System, many problems, I think we all agree, still persist. A significant amount of high-cost bonds held by the System has kept the average cost of borrowing for the System above the market interest rates for some types of loans, and the result of this high cost of borrowing has led to many of the System's best customers leaving, because obviously, they were able to find lower interest rates elsewhere.

At the same time, nonaccrual loans continue to be a large drag on the System's resources. The solutions to these problems may be more complicated than stating them.

Simply addressing one area such as interest rates, or high cost of money, or nonaccruals, just increases the problems in other areas. Solving the problem is much like trying to overstuff a suitcase: When you fit everything in one side, something pops out on the other.

So, there are a number of solutions that have been suggested, and I am sure some of those will be discussed this morning, but let me say again, we must be very mindful of the consequences of any singular solution.

I think we can all agree, that the goal in last year's legislation was to help the System by enabling it to provide adequate credit at affordable rates. That must continue to be our goal, both for the short term and the long term. Our purpose, therefore, this morning, is to find out how well that goal has been met by last year's legislation.

We have two witnesses this morning, and I know there will be many questions from Senators, so I am going to stop here in the interest of time, and I know that other Senators will be willing as well to leave ample time for questioning. Our two witnesses, as the Senators know, are the Honorable Frank Naylor, who is Chairman of the Farm Credit Administration, and Mr. H. Brent Beesley, president and chief executive officer of the Farm Credit Corporation of America.

Senator Zorinsky.

STATEMENT OF HON. EDWARD ZORINSKY, A U.S. SENATOR FROM NEBRASKA

Senator ZORINSKY. Thank you, Mr. Chairman, and I am glad that the committee is holding these hearings on the financial condition of the Farm Credit System.

The testimony of today's witnesses, Frank Naylor, the Chairman of the Farm Credit Administration Board, and H. Brent Beesley, the president of the Farm Credit Corporation of America, will be helpful to us in assessing, one, the performance of the System since the enactment of the Farm Credit Amendments Act of 1985, and, two, the likelihood that the System will require Federal assistance in the foreseeable future.

A financially viable Farm Credit System is of great importance to American agriculture. It has been a primary source of reliable credit for our farmers and ranchers for 70 years. The System had its beginning in 1916 with the establishment of the Federal Land Banks, and in the 1920's, the Federal Intermediate Credit Banks were established to discount loans for agricultural lenders.

During the 1930's, the services of the System were expanded with the creation of the Banks for Cooperatives and the Production Credit Associations.

The Farm Credit System survived the Great Depression and subsequently repaid the Government seed money that had been invested in the institutions. It is indeed a reflection of the dire state of the agricultural economy in the United States, that the System has recently experienced a great deal of stress.

According to the General Accounting Office, the Farm Credit System incurred total net losses of $2.7 billion during 1985. All of

the institutions of the System, except the Banks for Cooperatives, suffered substantial losses.

The Federal Land Bank's losses, alone, were $2.1 billion. The Omaha Land Bank, which serves the States of Nebraska, Iowa, South Dakota, and Wyoming, had a negative net income of over $350,000 in 1985. The Omaha District's Production Credit Associations had losses of over $200 million.

The Farm Credit Administration recently estimated that the System will incur losses this year totaling approximately $1.7 billion. Such a level of loss, while less than last year's, is clearly disturbing. I look forward to hearing from today's witnesses as to when they believe the financial health of the System's institutions will improve, and what legislative action, if any, would be helpful in hastening the recovery.

Last fall, when the committee held hearings on the difficulties facing the System, I said that we needed to make it clear to the financial markets and investors in the Farm Credit System that the Federal Government stands ready to assist efforts by the System in maintaining the System's vital role in financing American agriculture. Finally, I said that whatever action we took must be sufficient to assure farmers that they will be able to obtain credit at reasonable rates of interest. I said that a solution that assures credit availability but assures it at only a higher cost is not a real solution to the farmer's problem.

I hope that the witnesses today, in their testimony, will tell us to what extent they believe the goals I outlined last fall were furthered by the enactment of the Farm Credit Amendments Act of 1985.

Thank you.

The CHAIRMAN. Senator Cochran.

STATEMENT OF HON. THAD COCHRAN, A U.S. SENATOR FROM MISSISSIPPI

Senator COCHRAN. Mr. Chairman, let me first thank you for scheduling this hearing. It is very important that the committee take a look, at this time, at the Farm Credit System, because some of us worry that it may be on the brink of collapse, or falling apart.

Certainly, the interests of farmers and borrowers are not being served by the System, in my judgment, and change needs to be made now, to help permit local managers to set their interest rates at more competitive levels.

The better borrowers are leaving the System and going to borrow their money from other institutions because they can get better rates.

They are in trouble because of the inflexibility of the System's regulators to help serve the needs of borrowers and help protect the System from demise.

I have introduced a bill.[1] It may not provide the best answer, but it is an effort to move the System toward providing more competitive rates to its borrowers.

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[1] See p. 111 for a reprint of the bill (S. 2770) introduced by Senator Cochran.

I am happy to be able to advise the chairman, and other Senators, that at this time we have 22 cosponsors of the bill, here, in the Senate, 12 Democrats and 10 Republicans. It is a bipartisan effort.

I hope the committee will report the bill out in time for action to be taken before this Congress adjourns for the elections in November. I am anxious to hear the testimony of those who are coming to testify this morning, and look forward to the opportunity to discuss the bill, and the other issues relating to the Farm Credit System with them.

The CHAIRMAN. Thank you, Senator. Senator Leahy.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

Senator LEAHY. Mr. Chairman, I, too, want to join in expressing my appreciation for this hearing being held. Farm credit issues are of great importance to farmers in every part of the Nation and to residents of rural communities. My State is made up of 251 communities, 250 of which are rural.

Senator Cochran has spoken of his bill, S. 2770. I am proud to be a cosponsor of that bill. I think it is an extremely important one.

Senator Cochran made the point that the bill is not a partisan bill. I would not even call it a bipartisan bill—it is a nonpartisan bill. S. 2770 is an essential bill, and I commend Senator Cochran for the authorship of it.

Nearly a third of the total farm debt outstanding is held by the Farm Credit System. The Farm Credit System is a major lender in the United States. But the System has suffered a $2.7 billion loss in 1985. It cannot continue to suffer losses of that magnitude. While the System is making progress toward self-help, certain actions of the Farm Credit Administration have impeded actions by the System to extend loans to farm borrowers at a lower interest rate, and that may have hurt the System, rather than helping it.

I believe the lower cost of funds now available to the System should be reflected in lower borrowing costs to the farmers. In fact, without this ability to reduce interest rates, the Farm Credit Banks can become uncompetitive. They lose business, and never will escape their current dilemma.

Mr. Chairman, I have a number of comments, but I would rather hear from the witnesses. I ask that my entire statement be made a part of the record.[2]

The CHAIRMAN. Without objection.

Senator Dixon has been called to another meeting, and he has just provided us with a copy of his statement. It will be made a part of the record.[2]

Senator Melcher.

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[2] See p. 51 for the prepared statement of Senator Leahy and p. 52 for the prepared statement of Senator Dixon.

STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM MONTANA

Senator MELCHER. I am glad to see Mr. Naylor and Mr. Beesley here. I do not know that you are making any headway with the Farm Credit System. You are going to show less losses in 1986, at the end of this year, assuming that your projections are correct, than you had last year. However, that is on about one-third less loans outstanding, and it is with a full billion dollar drop in your surplus, if I am not mistaken, and it is probably a $2 billion drop from the year before that.

When you say that rather than having a $2.4 billion loss in 1985, you think you are going to end up in 1986 with a $1.7 billion drop, but your surplus is about $1 billion less—I do not know whether you are making any headway.

I am going to echo what has been said here by Senator Cochran. It is a losing game unless you get interest rates down to where borrowers are staying with you. There will not be much of a Farm Credit System left. It will deteriorate about 10 percent a year. I do not see anything in your plan that really guarantees you are going to get interest rates down quick enough to hang onto your customers.

As you lose those good customers, there is precious little left to the Farm Credit System. I fear that what we are witnessing is about a 5-year demise of the Farm Credit System. One or 2 years have already gone by, and another 3 years are coming up. We do not know what will be left. What has been a steady, sound borrowing system, necessary for agriculture in this country, will be virtually wiped out.

I hope you will address in your comments just how you are going to get interest rates down so you can hang onto these borrowers. They must have a chance to come out. To talk about an 8 percent, for just a few of them, as an interest rate, and 11 or 12, or 12½ percent for 90 percent of them—just does not give us any assurance that you can hang onto those customers, and therefore keep the System intact. I will be listening.

The Chairman. Which takes us to Mr. Naylor. Maybe you will answer the question forthwith.

STATEMENT OF HON. FRANK NAYLOR, CHAIRMAN, FARM CREDIT ADMINISTRATION

Mr. NAYLOR. Well, we will certainly try, Mr. Chairman.

Mr. Chairman, if I may, just for a moment, before making some comments, take this opportunity to introduce to you, and to the committee, two of the most important executives in the Farm Credit Administration who have recently joined the Agency and for the first time would be before this committee.

First, I would like to introduce Dave Baer, who is chief examiner and director of the Farm Credit Administration's Office of Examination.

He has most recently served with the Office of the Comptroller of the Currency as Director of their Denver field office, and was responsible for the examination of national banks.

He has received numerous awards from the Department of Treasury and is considered one of the premier bank examiners in the United States, and is a graduate of the Graduate School of Banking, University of Wisconsin.

Also with me today is Michael J. Powers, who is director of the Farm Credit Administration's Office of Analysis and Supervision.

He also joined us from the Office of the Comptroller of the Currency as director of administration for the entire northeastern district of that operation, covering 12 northeastern States. He is also a recipient of numerous awards and is also considered one of the premier bank examiners in the United States, and is a graduate of the Graduate School of Banking at the University of Delaware.

Mr. Chairman, I have asked them to join us today so that you and the members of the committee, if you so desire, would have the opportunity to get input from two of the finest professional bank examiners in the country that have seen fit to join our operation and to assist in resolving the System's problems.

The CHAIRMAN. Very well. Thank you, gentlemen, for being here.

Mr. NAYLOR. Mr. Chairman, if I may, I would like to take just a few moments for some opening observations.

You have asked us, and particularly myself as the chairman to share with this committee an evaluation of the problems being faced currently by the System and the progress made to date to counter those problems.

I certainly understand, and share with the members of this committee, the concern for the debt problems being faced by individual producers all over the country. I think it important that as we evaluate both System activities and other matters which may be before this committee. We all must answer the question of whether the actions are of genuine value to individual producers, or whether the results might end up being more in the direction of relief, or relief of responsibility in some instances, for individual managers. In looking specifically at System problems, I think we need to put a few things in perspective. First and foremost affecting the System is a general paydown of agricultural debt in this country, from a peak of $215 billion. American farmers are rapidly paying down debt so they can obtain a competitive position with all lenders, not just the Farm Credit System.

The total agricultural debt is down to $180 billion, and continuing downward. It is a shrinking market. All financial institutions in the agricultural lending field are observing a downturn in the volume of business as farmers redress their debt structure in an effort to become competitive.

The System is feeling the impact of past imprudent lending practices, and as a result, the substantial losses that will ultimately have to be paid out. These losses must be dealt with. The System is still feeling the very strong effect of the impact of those losses.

It is also having to deal with a total of some $8 billion of nonaccrual loans, which I will address shortly. Mr. Chairman, this is a very substantial and major problem affecting the System's ability to offer competitive interest rates and to properly service the needs of individual producers.

The System, particularly in the area of the Federal land banks, is reeling from its involvement and uncontrolled purchase of ex-

tremely high-cost debt in the late 1970's and early 1980's. Fifty-three percent of the Farm Credit System's total bonds outstanding are securities assignable to the Federal land banks and bear interest rates in excess of 11 percent; 10.8 percent of the land banks' total security portfolio bears interest rates in excess of 14 percent. Half of those securities have maturity dates between 1990 and the year 2005. None of those securities were issued with call provisions. This decision made by System management several years back will now haunt the System for some time.

The Federal land banks' total average cost of funds is 10.66 percent. That is without adding their cost of doing business. If you add that, then the spreads that they are now experiencing, the break-even point for Federal land bank operations approaches 12 percent.

The FICB cost, and the PCA cost of funds is significantly better, with an average cost of 7.88 percent to those institutions, and for the Banks for Cooperatives, an average cost of 8.1 percent.

Mr. Chairman, there has been a great deal of discussion about the question of competitiveness and what needs and can be done about it. I would simply like to make several observations in this regard because I think there has been a considerable amount of misinformation and misleading information that has appeared from time to time with regard to this situation. First, I would remind, again, as we made in our opening observations, that a general paydown of agricultural debt is occurring, and a shrinkage of everyone's portfolio is inevitable as farmers restructure to reduce their total outstanding debt.

Second, without significantly improved service on the part of the delivering institutions of the Farm Credit System, and a restoration of member confidence in some parts of the country, no amount of adjustment in interest rates will materially improve the individual producer's view of, or quality of, service being received from the Farm Credit System.

There have been a number of comments that rates are excessively high, that noncompetitive rates are not being offered by the System, and that this is a result of the Farm Credit Administration's actions. That simply is not the case.

Four districts in the Federal Land Bank System are currently offering to qualified borrowers rates as low as 9 percent. Eight districts are offering rates below the 10-percent level.

The System has not fully utilized the interest rate reduction authorizations of June and July, as of this point in time. I would simply observe that FCA's procedures for interest rate reductions which are already in place were set in place as a means of maintaining safety and soundness of System institutions until the capital adequacy regulations, which exactly parallel the practice of other regulators of protecting safety and soundness of financial institutions, become effective a little later this year. The System approached the Farm Credit Administration in early June and July, indicating that it was their view that a 50-basis point reduction would permit its institutions to take the appropriate steps to retain their best customers, and to be competitive in all respects. Indeed, the interest rates that I indicated to you as now available are specifically targeted at many of those customers.

Indeed, the Springfield district has already put $90 million worth of business on the books, at 9-percent interest rates.

Frankly, Mr. Chairman, the regulator went beyond that. We told the System that not only would we grant them that particular request, but for those banks that effectively work on behalf of their customers, we would grant, as requested, additional reductions in interest rates at the end of September.

And indeed, two districts have already stepped forward and asked for such reductions. Sixty-six points were granted to the Springfield district within the last couple of days. This brings the total reduction in interest rates since July 1 to over 116 basis points for that district.

An additional 48-basis points, exactly what the district asked for in the case of the Baltimore district, was also granted within the last few days, effective the end of this month, bringing their total reduction to more than 98 points. We expect that essentially all additional districts, if they were to request such additional reductions, would receive them. But they have not yet requested additional reductions.

Our principal concern, and some of the discussion with regard to competitiveness, is not whether the System has the ability to be competitive in retaining its best customers. It has that authority now and the districts are already doing so.

The question becomes a more basic one, that I think Senator Cochran, you and others are concerned with, reaching beyond to the entire range of borrowers and the impact on all borrowers, not simply the best borrowers. That is the question of continued high cost of funds.

We are concerned with regard to the System's interest, operating systems, as to what will be the real effect and objective of some of the changes that are being considered.

We are concerned that within the language of proposed legislation, the impact would be to effectively deregulate these institutions, and create what would amount to a national nonregulated, nonbank bank, not in the best interest of individual producers, and certainly, not in the best interest, Senator Leahy, of the strong institutions.

The legislation, as our counsel reviews it and evaluates it, would indicate that poorly managed or weak units, under the current proposal, would have the capacity, without supervision, to lower their interest rates, without regard to the safety and soundness of operations, and not only dissipate their remaining assets, but those, for example, of the Springfield bank, would be required, under their joint and several obligations, to pay for any institution that is poorly run, and should abuse the right to reduce interest rates.

The concern from the perspective of safety and soundness is one that all of you here, and I have talked to many of you individually, share with us as a major concern, and is one which we have to approach with great care.

I would also suggest that we need to be very careful in asking whether the proposal indeed does reduce interest rates to individual borrowers, and indeed, the proposal only permits but does not require that such a situation occur. Looking at the System's proposal for restructuring that it has under discussion, one might ask

whether or not this proposal is simply changing the center of interest rates from the FCA to another central entity, rather than necessarily specifically assisting individual producers, which I think is the objective of the members of this committee.

Let me just briefly, in closing, touch on what we view, as the regulator, as the most important things the System itself needs to do to help individual producers, and it has an obligation to do, and which it has done with varying degrees of success. First, the System must effectively deal with its high-cost debt. While individual districts have made some successful attempts at doing this, it has not been done on a coordinated systemwide basis.

Investment bankers and Wall Street tell us that they are prepared to work with the System with reasonable degrees of risk, to do that, and in so doing, permit significant additional reductions of rates to individual borrowers.

Discussions in areas such as interest rate swaps, moving down the yield curve, and other technical options, which the investment banking community is prepared to work with the System on to reduce its cost of high debt, have not been adequately or fully explored or used on a coordinated basis. As a result, individual borrowers are continuing to suffer from the effect of these high-priced loans.

Perhaps most significant is the System's treatment of nonaccrual loans. While the System generally has policies and programs in the process of being developed, and many districts have at least some initial effort underway, the effective reduction of nonaccrual loans simply is not being carried out by the System as a whole.

What we are talking about is the impact on individual producers. We are talking about System institutions going out and seeing individual borrowers, and restructuring, and reworking loans if appropriate, effectively to put them back on some sort of accrual status, both to the benefit of the System and to the benefit of the individual borrower. This simply has not been done by the System in an adequate fashion or nearly aggressively enough. As the regulator, we will continue to put every pressure we have at our disposal on the System to aggressively deal with this probably most fundamental problem to its long-term health and survival.

There is probably no other single thing that will have a greater impact on the long-term survival of this System than the effective resolution of this particular problem.

There is a great deal of concern about the System's approach to the management of its acquired properties, which now total $1 billion, and how those are brought back on to the market, how those are disposed of, and whether or not current members are being afforded an equitable opportunity to participate in, or to acquire properties that the System may put on the market again.

There are major concerns by our examination division, and leaders within the administration, with regard to the general credit administration procedures of the System.

There are major flaws, and indeed, a number of the districts still have unsatisfactory credit administration policies, which, if any assistance were provided, either from other districts or externally, can well be dissipated without any discernible improvement in the System operations and should raise significant questions of concern

by the members of this committee. Member relations, gentlemen, continues to be a major, major problem for this System, particularly in the Midwest. Any cooperative—and those of us who have grown up around cooperatives understand that very well—which loses the confidence and trust of its members, no matter what its financial shape, is destined to fail as a business entity.

The System must be more forthright with its members. It must specifically provide them the information that they have the right to know with regard to eligibility for reworking of loans, with regard to eligibility for preferential interest rates, and with regard to the operating practices of the individual institutions.

I would candidly tell you that our examiners to date have found little evidence that an effective program to reestablish member confidence is adequately underway.

The System must also substantially reduce its cost of doing business. It is currently spending about $800 million a year to operate the administrative cost of its system. This is simply too much.

Simply moving organizational boxes around, however, Mr. Chairman, does not accomplish a reduction in expenses. Most of the costs we are talking about are costs that can be dealt with even within today's organizational structure and with significantly improved services to the individual units. The System has, and is, in the process of looking at its costs for duplicated services, which are quite common among the banks; for the high cost of basic service that is provided; even, if you will—and forgive me for being a little political I suppose in this—a significant cost of Washington representation, as we have seen districts send their own staffs, hire their own individual representation here in Washington, have a system-wide representative, and have another trade organization, many of whom often are speaking in the exact opposite directions among one another, and all at a significant cost.

Mr. Chairman, while the problems of the System are severe, there is much the System can and should be expected to do for itself.

And while the financial situation of the System, has represented some substantial losses recently, and there are additional losses to be incurred, much of this has been a result of properly reserving for and recognizing losses that should have been dealt with several years ago.

The future situation depends upon the System's willingness to continue to take appropriate steps. I am greatly encouraged, despite these problems that we have outlined, that the System indeed is attempting to cooperate with us in that regard, and with its Capital Corp., which is becoming a major factor in helping address the System's problem, as was intended in the legislation.

I would only ask the committee to approach with great care any changes to the very carefully and very well-done legislation that this committee helped so strongly to implement last fall. Undoing the 1985 amendments, intentionally or unintentionally, would put us in a position where management, which by experience, and examination, and record has acted imprudently, could again be placed in the position of acting without proper supervision and without proper regulation to the detriment of individual members and the banking system as a whole.

We can do a great deal for individual producers. That objective is justified and we should work together to accomplish it.

We should not, however, permit the safety and soundness and the future of this System and its institutions to be jeopardized by irresponsible and unregulated management actions, to the detriment of strong as well as weak units.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Naylor.

Before you begin, Mr. Beesley, I have been called to the floor.

I am going to ask the distinguished chairperson of the subcommittee of jurisdiction, Mrs. Hawkins, to take the chair and preside in my absence. If you will come here.

Senator HAWKINS [presiding]. Mr. Beesley.

STATEMENT OF H. BRENT BEESLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FARM CREDIT CORPORATION OF AMERICA

Mr. BEESLEY. Madam Chairman, members of the committee, my name is Brent Beesley, and I very much appreciate this opportunity to testify today on behalf of the Farm Credit System.

I am the chief executive officer of the Farm Credit Corporation of America, and a member of the Farm Credit Council Legislative Committee.

The Farm Credit Corporation of America was organized in July 1985, by the 37 Farm Credit Banks to set standards, establish policy on national issues, and to be the System's national spokesman.

While we often speak of the Farm Credit System as if it were a single entity, we must remember that this System consists of 488 separate legal entities, each with its own farmer-elected board of directors, and fiduciary responsibilities.

At times some misconstrue our diversity as weakness. We view it as one of our strengths.

During the last several days I have been meeting in Albuquerque, NM, with the presidents and the directors, of the 12 Farm Credit Districts, and the Bank for Cooperatives. While each of us does not agree on every issue confronting the System, we do share a common vision of the vital role of the Farm Credit System in the future of American agriculture, and we are united in our appreciation for the strong support, and leadership, which this committee gave the System last year.

Your foresight and determination led to the passage of the Farm Credit Amendments Act of 1985. This legislation established a blueprint for the future of the Farm Credit System.

Now Madam Chairman, I would like to have my prepared statement put in the record,[3] and I will skip over some of the things that Mr. Naylor, I think, has very appropriately mentioned with regard to the System's current financial condition, and go to where we see the System going in the future.

Let me say that the System has adopted a business plan, a copy of which is included in the materials which you have, which we believe addresses each aspect of our survival and recovery.

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[3] See p. 52 for the prepared statement of Mr. Beesley.

I can represent to you that the System is addressing each of the issues it confronts. There are more than 45 strategies in this business plan, one of which is the development of periodic forecasts of the System's financial condition.

We have just completed the latest round of such forecasts, and notwithstanding the many uncertainties surrounding these projections, I would like to share them with the committee today.

First of all, for the full year, 1986, we project a loss to be approximately $1.7 billion. Losses are projected to continue through 1987 and 1988, although they will decline significantly from year to year.

We expect the earned surplus to continue to decline and to be negative by the end of 1988. Loan volume, as Chairman Naylor has said, is also projected to decline from $66 billion in December 1985 to less than $50 billion as of December 1988.

In evaluating projections, the committee should appreciate that there are several uncontrollable factors which may significantly impact these earnings.

While these projections represent our best current assessment of the future operating results for the System, it would, in our judgment, be inappropriate to use these projections to reach conclusions, regarding the necessity of Federal financial assistance, or the timing of that assistance.

I desire to report to you today, that it is the position of the System's farmer directors and its management, as reaffirmed in Albuquerque this week, that our desire is to avoid and minimize the need for Federal financial assistance, and that we have absolutely no plans to seek such assistance at this time. We continue to meet with officials at FCA, Treasury, the Wall Street community, and others, to explore ways to resolve or reduce our problems in order to avoid the necessity of such financial assistance.

We have confidence in the process that was implemented, or established in the recent legislation, and believe that that process will work in the best interest of the System and its borrowers.

The System's self-help efforts are critical in this process, and in view of the pending challenges, there is a great deal of uncertainty about the ability of the Capital Corporation to mobilize System resources to assist troubled institutions.

I would like to address that. We are greatly troubled by this issue and the potential consequences it has on the System's future.

Although the Capital Corporation is only now in the process of making its first assessment, System institutions, pursuant to voluntary agreements, have already transferred, or committed nearly $1 billion of assistance from strong banks to weaker banks.

Virtually all of this has occurred since the passage of the 1985 amendments. The Farm Credit Corporation of America has opposed efforts of the Amarillo PCA to withdraw from the System. Likewise, on behalf of the System, we intend to support the constitutionality of the 1985 amendments in pending future litigation.

The Farm Credit Corporation of America has filed extensive comments with FCA concerning aspects of their recent assessment regulations.

We are hopeful that these comments will be quickly reflected in revised regulations, because, in our view, revised regulations would

significantly reduce the concerns of many System entities on the operations of the Capital Corporation.

As you may know, a couple of System banks, Springfield and Texas, have filed legal challenges to FCA's regulations. We hope that FCA will act promptly to address those concerns, so that the Capital Corporation will be able to perform its function.

Furthermore, Madam Chairman, we are concerned about the FCA's actions to separate the Capital Corporation from the rest of the System.

By issuing arbitrary regulations without any statutory basis, FCA has prohibited many of the most able, and dedicated System leaders, from running for election to the Capital Corporation board.

FCA has also made it difficult for the Capital Corporation to draw on the talented and capable personnel of the Farm Credit System. Through these regulations, FCA has made the Capital Corporation less effective, and has delayed its progress in System self-help. During this period of unparalleled financial stress within the System, and in agriculture generally, the System directors, and management, have attemped to focus their attention on business policies, to maintain the System's ability to serve the credit needs of agriculture.

In May this year, the System, on its own initiative, adopted policies regarding loan restructuring and forebearance, and the management and disposition of acquired property. Those policies are contained in the materials which you have before you.

These new policies were to be implemented as of July 1 and they state very clearly that the System will use forbearance and debt restructuring as preferred alternatives to foreclosure.

We recognize, however, that not every borrower can survive the current depression in agriculture, but we believe these policies are responsive.

I would like to report that year to date, through July 31, 1986, over 8,000 loans have been restructured, or otherwise received special forbearance.

I regret, however, to report, that there are almost 10,000 loans in foreclosure.

We have responded I think, as best we can, to what is clearly the most widespread concern of our borrowers, and that is the high and noncompetitive interest rates. Last May, the System adopted a Farm Credit System model pricing program which is also included in your materials.

This program was developed with the help of the borrowers, the directors, and also the System management.

I agree with the comments that have been made here this morning that borrowers need interest rate relief.

The System needs to maintain its customer base in order to preserve the earnings necessary to work through its problems, over time.

It has become evident that continued regulatory control over System interest rates will prevent us from implementing our new pricing programs.

At the Albuquerque meeting yesterday, there was an informal vote taken, and there is wholehearted support for Mr. Cochran's bill, S. 2770.

No financial institution can mount a recovery by charging non-competitive interest rates. Certainly, those of you who have labored so hard to attain enactment of the 1985 amendments, did not do so with the understanding that the System would lose its ability to provide credit to eligible borrowers on reasonable and competitive terms.

The System has the self-discipline necessary to administer a responsible lending program as contained in the model pricing program. The issue before us is whether or not the farmer directors and their management, or the regulator, will determine what rates are appropriate. I cannot predict what future rates will be. It is my belief, however, that several districts have rates which are not competitive.

For example, one large agricultural lender in the Western United States, which has tremendous financial problems like the System, is currently undercutting the Farm Credit System's rates by between 2 and 3 percent.

If Senator Cochran's bill becomes law today, we believe that there will be a decrease in interest rates across the country.

This is because the marginal cost of funds to the System today is only 5.52 percent, plus approximately 25 basis points in spread over that. That 5.52 is the current 6-month Treasury yield.

The real issue is who is going to be responsible and accountable for the pricing function. There is no question that the present law gives this authority to FCA but this is inconsistent with the role of an arm's length regulator.

Madam Chairman, there is no regulatory body in the United States, that I am aware of, that has ever required any institution to charge above-market interest rates as a means of preserving capital, or improving earnings.

I do not think—and we have done some research on this—we can find one example where the Comptroller of the Currency, the Federal Reserve, the Federal Home Loan Bank Board, or the FDIC, has asked failing institutions to increase their rates as a means of minimizing their losses.

As the Madam Chairman well knows, when I was Director of the FSLIC, we had numerous problem savings and loans in Florida. It never occurred to any of us to ask them to increase their mortgage rates as a means of resolving their problems.

We have presented some projections as to what lowering rates will do to the System. It is impossible to prove the validity of our assumptions but we believe that they are reasonable and we call the attention of the committee to those forecasts.

In any event, it is clear that a loss to the System, as a result of reducing its rates, is substantially less than the benefit that would be received by the borrowers.

There is nothing in Senator Cochran's legislation which prevents FCA from exercising enforcement powers to correct bad management practices and that is the last thing that we would support.

This legislation does not commit Congress to any open end, multibillion dollar legislation package. It will, in our judgment, if passed, enable the System to fulfill its congressional mandate to be a dependable source of competitively priced credit to farmers, ranchers, and cooperatives. If FCA or others really believe that the

American farmer should bail out the Farm Credit System through excessive interest rates, and if we are not going to charge competitive interest rates, then why don't they compel us to raise our rates another three basis points to recover the entirety of our projected losses.

Madam Chairman, we believe the Farm Credit System has a key role to play in supporting and strengthening U.S. agriculture. I can assure each of the members of this committee, that the Farm Credit System will do everything within its power to recover from its current economic problems and return to long-term profitability, without the need for Federal financial assistance.

We continue to meet today the financial services and credit needs of our farmers, ranchers, and cooperatives and we appreciate this opportunity to maintain an open and candid dialog with this committee.

Thank you.

Senator HAWKINS. Thank you.

Senator Cochran, would you like to ask your questions at this time?

Senator COCHRAN. I am going to have to do something else for about 10 minutes. I will be right back. Thank you, Madam Chairman.

Senator HAWKINS. All right. I will ask the Senators to restrict their time to 5 minutes per witness, please.

Mr. Naylor, the 1985 farm credit amendments took steps to separate the Farm Credit System from this regulatory body.

The purpose of the act was to establish a relationship between the Farm Credit System and the Farm Credit Administration, similar to the relationship of the bank regulators and the commercial banks.

What progress has been made in developing a new regulatory framework and establishing new examination procedures, and instituting new accounting procedures that will ensure that System institutions are operated in a safe and sound manner?

Mr. NAYLOR. We have made a good deal of progress in this area, and indeed, I think we need to make the record clear, that neither Mr. Duncan nor myself, as members of this board, have any desire to set or give individual interest rate approval to the Farm Credit System.

That is not an appropriate function of the regulatory body. The proposed regulations, which will be in effect by year end, exactly parallel that of the other bank regulators in establishing the basis for safety and soundness with regard to capital adequacy, which I might observe was one of Mr. Beesley's principal concerns with the savings and loan industry.

And that is the appropriate way to deal with that problem. Of course, capital adequacy depends on either a capital call, or on the interest rate setting that is done by the individual institution.

We have no objection to that portion of the legislation from that perspective. We are deeply concerned, though, that additional portions of the legislation being discussed would effectively undo what the commitiee and what the Congress did last fall, by eliminating our ability to adequately and appropriately enforce safety and soundness of individual institutions or the System at large. The

effect would be that poorly managed institutions would have the capacity to drain what remaining funds are available from the rest of the System, and do so very quickly.

If the System institutions were to move forward without restriction and without taking into consideration their cost of funds or cost of doing business, we expect that perhaps as much as a $1.2 billion annual cost is associated with the impact of the proposed legislation. Such action would very quickly have an adverse impact on the System, and ultimately would put Congress in the position of either having to address an assistance issue or saying that the System would be allowed to fail.

We have fundamental and strong concerns with the issue of safety and soundness. With regard to other regulations regarding our separation as a regulatory institution, we are very rapidly withdrawing from all the extensive prior approvals that used to be part of the old Farm Credit Administration's interference in day-to-day management.

We do not belong in that area and we have no place interfering in the day-to-day management of the System, and have no desire to do so.

Our fundamental concern will continue to be focused, Madam Chairman, on the question of the safety and soundness of the operations, that the institutions are taking appropriate steps to deal with their basic problems, and that those institutions which are not have appropriate enforcement actions taken on them.

And we have already begun to take enforcement actions where those are appropriate. They have not been publicized because I am sure, as you are aware, as is the case with other bank regulators, enforcement actions are private arrangements between the banks, and are not made public unless the receiving institution elects to do so. That does not mean that they are not being done. Enforcement actions will continue to be done, if necessary, to deal with the most serious problems of the individual institutions.

Senator HAWKINS. Since the Farm Credit Administration currently has the power to guide System interest rates, can you describe for the committee the specific criteria being established by the Farm Credit Administration in deciding whether a System can lower its rates?

Mr. NAYLOR. Essentially, we reviewed with Mr. Beesley, and other presidents, earlier in the year, what they felt was necessary to give them the discretion to be competitive.

We did not set about to set specific interest rates and indeed have not done so. Each bank in each district sets its own interest rates.

For example, the Springfield district has a range of rates available to its land bank customers that range from 9 percent loans to 12.75 percent loans. On the other hand, the lowest cost district in funds in the System, the Texas district, has a range of 10.83 to 11.13 that it offers its customers.

Those decisions are the decisions of the individual institutions and are not a decision of the Farm Credit Administration.

We have no interest in setting specific interest rates. We have a concern with the safety and soundness. The adjustments that were authorized, and the additional adjustments, I think it should be

quite clear to the members of this committee, will result in operating losses over and above those already anticipated, of $200 million for the last 6 months of this year, and $400 million for the subsequent year.

The proposed legislation would very likely add an additional $1.2 billion, if some responsible control and consideration of operating overhead and expenses is not included.

Senator HAWKINS. Mr. Beesley, could you respond to the same question.

Mr. BEESLEY. Thank you, Madam Chairman.

The Chairman of FCA has just said they do not want to be in the interest rate-setting business, and their concerns are with safety and soundness.

We would support that and agree with that. The only area I think where Mr. Naylor and I differ, is that whether or not it is unsafe and unsound to charge market rates, and it is our view, as is embodied in the Senate bill 2770—it simply states that if you set competitive rates, you are not being unsafe and unsound.

And we believe very strongly, that no other regulator assumes that setting competitive rates is unsafe or unsound.

The Farm Credit Administration takes the position that if you do not have sufficient capital, that they will get involved in the rate-setting business. We think this is inappropriate.

Senator HAWKINS. Senator Boschwitz, do you have a question?

Senator BOSCHWITZ. Not at this time.

Senator HAWKINS. Senator Leahy.

Senator LEAHY. Yes; I do. I would refer back to Mr. Beesley's testimony. In view of my cosponsorship of Senator Cochran's legislation. I am intrigued by his statement that nothing in Senator Cochran's legislation prevents FCA from exercising its enforcement powers to correct bad management practices, nor does the legislation commit Congress to an open-ended multibillion-dollar assistance package. Mr. Naylor is obviously wrong.

But, before we discuss that issue, I have a question for both you gentlemen—with Mr. Beesley first.

FSLIC and the Treasury Department recently developed a proposal to use funds for regional home loan banks to leverage additional financing to zero coupon bonds.

Could such a concept, if adapted to the Farm Credit System, be used by the Capital Corp.?

Mr. BEESLEY. We believe that there is a possibility that creative financing of that type may have a place. The Capital Corp. has met with one of the major investment houses on Wall Street. The Farm Credit System, in conjunction with the Capital Corp., has met with another. We have asked them to explore all of the ways that they could think of to help us restructure our debt, or to otherwise find private sources of funds to go into the Farm Credit System.

At this point, frankly, it appears that there is some possibility that we may find some ways to avoid the need for Federal financial assistance, and that is of course our objective.

Senator LEAHY. Mr. Naylor, what is your view?

Mr. NAYLOR. Senator, we have examined that particular proposal at some length. There is a technical problem with that particular approach that might require legislation.

But there are a number of similar options we, indeed, believe the System has an obligation to explore that would significantly help their position. which they have not yet undertaken on a coordinated basis. We are continuing to encourage them to do so.

Senator, I appreciate and I firmly believe that the members of this committee do not intend to result in a deregulated situation for the institutions of this Farm Credit System.

However, if I might just make one quick observation in that regard. The reason the interest rates were originally in there is that the entire System, unlike any other financial institution, is jointly and severally liable for the actions of each unit within that System. However, there is no mechanism, other than the regulator, to take any action, should any individual institution among the 500 act irresponsibly or without regard to the safety and soundness of its neighbors.

The effect of the definitions and the basic language in sections 4 through 7 of the proposed bill, while well intended, have the effect of complicating, if not making it impossible for us, as a regulator, under current case law, to be able to engage in appropriate enforcement procedures, or to protect the interests, particularly, as an example, of your district.

Should one of the other districts or institutions within the System elect to irresponsibly set its interest rates well below its cost of funds, and——

Senator LEAHY. Let me ask you about that. I wonder if you are not being too inflexible on interest rates?

Suppose an institution that is now safe and sound, but has, or soon will have, its surplus capital drawn down because of loss sharing.

Can such an institution set its interest rates as its cost of funds decrease?

Mr. NAYLOR. The current——

Senator LEAHY. I mean, could they do this and be competitive?

Mr. NAYLOR [continuing]. The current proposed regulations do give discretion, even when funds are reduced, except to the very bottom levels to individual districts, as part of the effort to share capital around the System.

Our concern is more fundamental than that, however, in that what we are doing here essentially is saying that we are defining as safe and sound a practice being segregated out from the whole.

And by that I mean—and I would have to very strongly disagree with Mr. Beesley. The pricing question is not simply competitive pricing alone.

One has to consider what the cost of the money is that you have got to do your business, and what your cost of operations are.

And they have an obligation to reduce those as significantly as possible, and must consider them when setting interest rates.

You simply cannot buy pencils, if you will—and forgive the analogy—at 5 cents and say that if you can just sell them at 3 and enough of them, somehow it will be OK.

That is not the case. In and of itself, you have to consider the whole. Certainly, we agree that interest rates need to be brought down, and they are. Indeed, the System has the capacity to do that. We do not want to be in the individual ratesetting business, and

have no objection to section 3 of the bill, from the standpoint if the objective is to allow the institutions to set their own individual rates. The bill adequately and fully does that.

Senator LEAHY. Well, I think, Madam Chairman, as Mr. Naylor seems to disagree, or said he disagrees with Mr. Beesley on this, I wonder if we might hear Mr. Beesley's side.

Senator HAWKINS. Surely.

Mr. BEESLEY. Thank you, Senator.

As you, I am sure would know, the Springfield district is one of the strongest districts in the Farm Credit System, and it wholeheartedly supports your legislation.

It is not as concerned with what other districts may do with their pricing, given the mechanisms we have in place as a system.

As they are, with having to go to the regulator for approvals, in a very rapidly changing interest rate environment.

I might also say, regardless of the cost of your pencils, if somebody else is selling them for 4 cents, you cannot sell them for 5 and make it up on volume. You just will not be selling any. And that is the problem that we are facing with many of our borrowers. Our statistics show that in some areas over 70 percent of the repayments of loans that have occurred have been because of refinancing at lower rates with other lenders.

Senator LEAHY. Thank you.

Senator HAWKINS. Senator Cochran.

Senator COCHRAN. Madam Chairman, thank you.

I was told that in the July issue of Farm Journal, there is an article that says that since January 1986, 1,700 borrowers have left the St. Louis district of the Farm Credit System, and that 70 percent of those have refinanced their loans with other lenders.

Let me ask you, Mr. Naylor, if that is indicative of what is going on all over the country, and, if so, is that not contradictory to your statement that what is happening in the Farm Credit System is no different from what is happening in other lending institutions?

That farmers are simply paying off their loans or reducing their borrowing. It seems that if this is true in the St. Louis district, it means the Farm Credit System cannot exist for very long.

Mr. NAYLOR. Senator, I think—I do not know the source of those specific statistics—but the information which we have available to us indicates that there is a wide-scale, general paydown occurring of agricultural debt, that will and is impacting all lenders, including the Farm Credit System. Those borrowers that have the capacity to pay out are doing so, and there are perhaps a few of those remaining.

The System's problem in dealing with those borrowers who have the capacity to refinance is one of their own making. The System's competition currently is insurance companies offering 3- or 5-year fixed-rate loans.

The System, in 8 of its 12 districts, is offering, only recently, that same kind of loan to those same customers. They have the ability today—for example, in the Springfield district—to offer a 9-percent rate which is fully competitive in the industry, on the same basis as their competition, to the same customer, and indeed, have authorized that to occur.

There is no justifiable reason for the System, even under today's rate structure, not to be able to accomodate any borrower who has the capacity to restructure and qualify for restructuring from another lender.

Senator COCHRAN. Can you tell us at what rate the Farm Credit System is losing borrowers to other lenders?

Mr. NAYLOR. Senator, I do not think that anyone, because the commercial banking and insurance industry does not keep such data, and neither do we, in the direct sense, can give you those precise numbers.

The Farm Credit Administration is the only unit in the entire System that has the modeling capacity or technical capacity, at all, of that nature and, by and large, the data that we are seeing developed indicates that, to the extent feasible, most of what is occurring in the refinancing area, or if there is any refinancing at all, is a paydown in an effort to reduce total outstanding debt. That is where your best customers are actually going to put themselves in a more competitive position as much as anything.

I think the concern you probably have Senator, as I do, is that the System has the full capacity to provide preferential rates and fixed rate, head-to-head competition with other lenders for its best borrowers, and the borrowers who have the ability to refinance.

The poorest borrowers are going to have their loans restructured, we think not quickly enough, but we think the System hopefully is beginning to and will move more aggressively in that area.

The basic concern is the group that perhaps exists in the middle. That I think is the group you are concerned with. Indeed, this would apply not just to the Farm Credit System, but I would suggest to the committee that if our focus is individual producers, as I know yours is, Senator, and justly so, this is the group of individual producers we're concerned about.

It is not just the Farm Credit System that needs to look at that element of interest rates for that middle group that is not strong enough to refinance, but they are probably weak enough to be restructured.

Senator COCHRAN. Why is it that as the regulator of the Farm Credit Administration, you are seeking to retain the power to approve interest rates in advance, when no other regulator in any financial institution system has that same power?

Mr. NAYLOR. Senator, we are not seeking to retain that power at all, and I think that has been a great misunderstanding.

The proposed regulations which you have had for your review and are now before the Senate and out for public comment, take us out of the interest rate setting business, while using exactly the same standards as other regulators.

That standard of capital adequacy is the basis for determining safety and soundness. We have no desire to set individual interest rates. The only reason we have been involved in approving interest rate programs at all is to provide some interim regard to safety and soundness until the new regulations on capital adequacy are put into effect.

We have no objection to that particular situation.

Senator COCHRAN. Thank you, Madam Chairman.

Senator HAWKINS. For the record, when will they be in?

Mr. NAYLOR. Before yearend, Madam Chairman

Senator BOSCHWITZ. What was the question?

Mr. NAYLOR. How soon will the capital adequacy regulations, which will provide the same provisions as the other regulators, be in place, Senator. We expect they will be in place well before the end of the year.

Senator MELCHER. Mr. Naylor, General Motors announced a few weeks ago if someone would buy one of their new cars they would either give them up to $1,500 off or they could buy the car at full price, and get financing at 2.9 percent on 3 years.

I suppose some would call that imaginative financing. I think that might be a phrase that could be applied, all right, but I think it's rather a situation of where General Motors said they were going to reduce their inventory in order to make some money instead of having a big stock of carryover of 1986 models that weren't going to be sold.

You have an inventory of very high priced bonds that are going to have to be repaid. What is the current cost of money right now? What are your bonds selling for?

Mr. NAYLOR. The System's securities range from very short-term notes, in the 5½-percent range, up to, on long-term notes, closer to 10 percent.

Senator MELCHER. And what's a percentage?

Mr. NAYLOR. You mean the mix?

Senator MELCHER. Yes.

Mr. NAYLOR. It depends on which bank.

Senator MELCHER. Just rough.

Mr. NAYLOR. Roughly? The land banks are the problem banks, Senator——

Senator MELCHER. Just rough, real rough.

Mr. NAYLOR [continuing]. Average maturity, 2.8 years

Senator MELCHER. What's the percentage at 10 percent versus 5 percent?

Mr. NAYLOR. Fifty-three percent of the System's outstanding securities are at 11 percent or higher rates, most of which don't retire until 1988; half of those don't retire till the year 2005, or 1990 to 2005.

Senator MELCHER. So you're stuck with a horrible inventory?

Mr. NAYLOR. Yes, we are.

Senator MELCHER. What is the current cost of money to you?

Mr. BEESLEY. About 6 percent.

Mr. NAYLOR. Range, on average, depending on maturity, from 5 to 8 or 9, perhaps 10 percent in some cases.

Senator MELCHER. Can you borrow enough at 5 percent to buy out that horrible inventory?

Mr. NAYLOR. No, probably not adequately collateralized. The premium cost on a buyout of those securities, in our estimate, and I think the System's is extremely high. There are other less costly strategies that might be adopted.

Our estimate is about $2½ to $3 billion.

Senator MELCHER. Can you buy enough out at 5 percent and amortize that horrible inventory for a period of years so you could get down to lending some money at 7 percent?

Mr. NAYLOR. Not that low, no, I don't think so, Senator. At least not on long-term lending. The approach that the System has taken on an individual district basis has done a little bit of what you're suggesting. This is called interest rate swapping, in which the System swaps longer term high-priced debt for other maturities.

The System has not looked at that on a coordinated basis. There are some districts that have made very substantial swaps to their advantage, and we are strongly encouraging the System, either through Mr. Beesley's organization, or the Capital Corporation, to pursue your suggestion, through this and other techniques.

Senator MELCHER. You better do it pretty fast, because this horrible inventory you have gives reason to do it. Showing a continuous decline of net worth and fewer customers will get you to a point where you have nobody left so there is no Farm Credit System.

I don't believe that you can delay. I don't happen to think, Mr. Beesley, that the bill you've been describing, Senator Cochran's bill, gets there fast enough. I think this is about the third year in a row we've been approached, either by the Farm Credit System itself, or a combination of the Farm Credit System and the Farm Credit Council, to perform some magic in order to save the System.

I don't think there has been any magic. What we have seen has been almost a program of self-defeating mechanism to render the Farm Credit System obsolete and to let it all go under. If you continue to project out losing $10 billion worth of loans, no matter how you've described it, it seems to me that there's about 2½ more years to go and there is no more Farm Credit System.

I'm not in the business of endorsing these miniscule little adjustments. If there's some plan around to show that you're going to borrow some money at 5 percent, and amortize this bad inventory of high-priced bonds that you have at 11 percent or more, then I'm for it. What is needed is a plan which will immediately get the interest rates down for these borrowers to around 7 to 8 percent.

If you don't do that, you're not going to have them, and you're not going to have a Farm Credit System.

I've used up an additional minute over my 5 allotted. Thank you very much, Madam Chairman.

Senator HAWKINS. You probably sold several cars [laughter]. Senator Boschwitz.

Senator BOSCHWITZ. I thank you, Madam Chairman, and I hope you stick around for a while, Senator Melcher, because you really have put your finger on the pulse of it.

If the inventory of bonds that are held, notes that are held by the Farm Credit System are at a very high percentage, I'm not sure if the squabbling we see here between these two gentlemen is anything other than academic. So that one of my questions is I'd like to see a list of those holdings, and perhaps if you could get one to Senator Melcher as well and other members of the committee. But I would like to see a list of the holdings, including maturities. I don't know if I should ask that of you or Mr. Beesley.

I understood there was $18 billion in the 12- to 18-percent range, and some of it very long term. And Frank, you alluded to that. I don't know how to undo the horrible inventory that Senator Melcher speaks about without paying enormous premiums, and increasing the size of the debt.

I mean, what's the difference if you have $18 billion worth of debt at 14 percent, or $26 billion worth of debt at half the interest rate. I'm not sure you've accomplished anything. And you may not have the asset base to support that anyway.

I'd like to see a list. Is there any problem in getting that list?

Mr. NAYLOR. There is no problem in getting you a list, Senator, of the outstanding securities. I would agree with both the Senators that it is the view of the regulators that the two most significant problems the System faces are: Getting rid of or dealing effectively with the high priced debt; and the second issue is of more effectively dealing with their nonaccruals, which will simply—forgive the expression—eat their lunch if they do not more aggressively get at those. And I think the squabbling you refer to is over the more important issue to us as the regulator and to individual producers.

Senator BOSCHWITZ. Well, if you're not borrowing the money, there's not much you can do.

May I have that list by tomorrow, please? Which one of you gentlemen could provide that?

Mr. NAYLOR. I believe both of us should have that information, Senator, but I will advise your office as soon as we can back to ours.

Senator BOSCHWITZ. Tomorrow.

What is the present capital of the Farm Credit System? I want to ask some questions about numbers. You said it was $2.4 billion at the beginning of the year; probably $1.4 billion at this point.

I presume if you lost $1 billion already this year—or $2.4 billion at June 30, and it projects a decline to $1.7. Would you also please get to me the capital of the System by district? And would you please show, does the $1.7 billion at the end of the year include just earned capital or does that also include paid-in capital by the farmers?

Mr. NAYLOR. That's earned surplus. There's $4.59 billion of B-stock in addition to the $2.24 billion of surplus.

Senator BOSCHWITZ. I would like to see that as well.

Mr. NAYLOR. Senator, you should also note there's a $3.46 billion loss reserve, and that's included in those total risk funds.

Senator BOSCHWITZ. The $3.46 billion worth of loss reserve has already been reduced from the net worth?

Mr. NAYLOR. Yes, that's correct. The total risk funds are at $10.5 billion.

Senator BOSCHWITZ. That's not too bad. What happens if you start to invade the paid-in capital by the farmers? Are they all going to escape? Are they all going to say to hell with this and beat a path to the nearest local bank or other lender?

Mr. NAYLOR. That is a risk depending on the circumstances, and how the individual institution would handle that. And it is a major concern of ours, if you were to go into an impairment. There's not a technical reason for going or not to go into impairment, but there's certainly a customer relation——

Senator BOSCHWITZ. Also show me the reserves as they go from district to district, if you will, so that I can get a sense of that.

Also, if you will, the $1 billion of property, how is that accounted for, that you're now holding?

And has that already been applied, marked down to the $3.45 billion of the loan loss reserve, to account for that billion dollars' worth of properties?

Mr. NAYLOR. It has been adjusted, following general accounting practice procedures as required in the law, and I will give you exactly how that's incorporated in the overall statement, Senator.

Senator BOSCHWITZ. So the property that has already been marked down and as a result that will not impose itself on the roughly 10 billion dollars' worth of reserves that are around?

Mr. NAYLOR. Yes.

Senator BOSCHWITZ. That is correct, what I've just said?

Mr. NAYLOR. Yes.

Senator BOSCHWITZ. I will wait for another round of questions, in that case, Madam Chairman. I do have some other questions.

Senator HAWKINS. Thank you, Senator Boschwitz.

Senator BOSCHWITZ. I want to get the numbers straight, and I noticed, I just looked through this very rapidly, but I must say to Mr. Beesley that a very rapid look doesn't show the numbers. They're a bunch of forecasts that change from day to day. I get tired of looking at these Government forecasts, to be very frank.

I'd like to see what each one of the banks has, and how much capital it has, and how much reserves it has, and so forth. And also the inventory of its assets—not its assets, but rather what it has to pay for the money, and how that can be changed.

Mr. BEESLEY. May I make one comment, Senator? One very important point is that the current inventory of high-cost debt, roughly $18 billion, as times goes on and that debt repays, the cost of the remaining debt goes up, and in fact, increases up until 1992.

Senator BOSCHWITZ. What do you mean by that—the cost of the remaining debt goes up?

Mr. BEESLEY. I mean that the less expensive part of our portfolio is up front. The only way that we can reduce our cost of debt is if we are able to replace loans—excuse me, debt as it expires with new low-cost debt, and average the overall cost down.

This is why, as our loan volume decreases, it dramatically increases our problems. And this is why it is important to the System that we be able to retain market share and loan volume.

Our market share, over the last couple of years, has gone from about 34 percent of the total down to less than 28.

Senator BOSCHWITZ. How can that be? You were at a high of $75 billion and now you say you're at $66.6 billion, and the total volume of the whole farm lending was about $210 billion. It has gone down by at least the amount that you have indicated the Farm Credit System has gone down; I mean, the amount that's outstanding now is no longer $210 billion. It must be $190 or $180 billion. So that the whole thing has shrunk 10 percent, so you've shrunk 10 percent to 12 percent.

How could you lose market share?

Mr. BEESLEY. We've gone almost, over the period of time that I'm discussing, we've gone from well over $75 I think down to less than $60. That is a much larger decrease in loan volume than the overall shrinkage of the pie.

Senator BOSCHWITZ. You said net loan volume is projected to fall to 66.6 by December 31, 1985. What is it now? Pardon me, Madam Chairman, if my time is up.

Senator HAWKINS. That's all right.

Senator BOSCHWITZ. What is it now?

Mr. NAYLOR. Approximately 65, Senator.

Senator BOSCHWITZ. Sixty-five, as of June 30, or the latest accounting period?

Mr. NAYLOR. Midyear. The rate is about a 5-percent shrinkage rate, as I recall. I need to check that exactly for you for the current year.

Senator BOSCHWITZ. If it's 65 and the total volume is 185, you're still at about 35 percent.

Mr. NAYLOR. The biggest decrease has been the short-term lending, the PCA's that frankly lost, as all the lenders have lost, a good deal of volume to CCC and the Farmers Home Administration.

Senator BOSCHWITZ. Well, the PCA's were in the middle 20's, as I recall, and the farm land bank was about 40——

Mr. BEESLEY. We'll reconcile that number. I'm virtually certain that our market share has gone from about 34 to about 28. We'll substantiate that if we can.

Senator BOSCHWITZ. If you can do that. I don't think you can.

Mr. NAYLOR. Senator, I think that is about correct because of the substantial drop and share of the PCA's as a result of short-term debt flowing over to Government programs.

Senator BOSCHWITZ. Well, Frank, you can't be at 65 and the total volume of farm debt being at 180 something, you said, which still is 35 points.

Mr. NAYLOR. True. Two-thirds of the business is land bank business, so you don't have as dramatic an effect in the loss of PCA business as you do when it's real estate business. In that the System has sustained fairly much of its market share.

Senator HAWKINS. Mr. Naylor, officials of the Farm Credit System report to me that since the beginning of this year almost $95 million in land bank loans in Florida have been paid off ahead of schedule. The reason given is that current System interest rates are noncompetitive, so the best borrowers are rolling over their debt and going with different institutions. The Columbia District, which services Florida, has made it clear to me that while it's required under the 1985 act to make contributions to the Capital Corporation, it's becoming less competitive at home.

What's your view of the equity of this situation?

Mr. NAYLOR. Senator, the concern is justly retaining qualified customers. The Columbia Farm Federal Land Bank currently offers a fixed rate loan which is the only competition in the marketplace today, are fixed rate loans, offers a fixed rate loan of 9 percent to qualified customers.

The qualifications that any external borrower requires are essentially the same as what the land bank would require under similar conditions.

Now, the System does have the capacity to compete for its best customers, and we have strongly encouraged it to do so. There is a long record of this agency encouraging the System to adopt differ-

ential interest rates, and fixed rate loans to be competitive, and that we continue to encourage them to do.

Senator HAWKINS. Mr. Beesley, we were talking about this summary report of condition performance that we received in my office a couple of days ago. It's for the quarter ending March 31.

Responsibility for this report is now in the hands of the System. Do you know when the report will be ready for the second quarter?

Mr. BEESLEY. It's at the printer, I understand, and should be out within just a few days.

Senator HAWKINS. Why is it taking so long?

Mr. BEESLEY. Well, if you recall, we have, again, approximately 488 entities, and to gather that data together and get it printed, there's just some logistical problems in doing that. We hope to cut that time down dramatically over a period of time as we get the System using the same software and the same procedures throughout.

Senator HAWKINS. It's very difficult for us to operate without numbers.

Mr. BEESLEY. I can understand that, Madam Chairman. Our initial financial results are expected within about 5 weeks after the close of the quarter.

Senator HAWKINS. Mr. Naylor, what is your view of the impact of borrower flight on the System?

Mr. NAYLOR. We consider the impact of particularly good quality loan to be very serious; and from the outset we have strongly stressed the need for the System to engage in differential pricing and fixed rate loans to match the competition. And that has been the basis of the interest rate actions taken to date to accomplish that, and, indeed, the System has the ability, and indeed, it hasn't even fully used the interest rate reductions that were approved in June and July.

Senator HAWKINS. Mr. Beesley, do you have a comment?

Mr. BEESLEY. Well, I think there's a long list of efforts by the System to reduce interest rates. And there may be an example here or there where a System entity has elected not to fully utilize the 50 basis points which we were given but within a few days after that 50 basis points and rate reduction authority was allowed by FCA, the entire market went down by more than that amount.

I'd like to just mention, Madam Chairman, Mr. Naylor has referred to various capital adequacy regs. The System takes objection to the basis of those regs, and we're in the process of filing those comments with FCA.

But as the current trends go, virtually every System entity is going to be drawn down through assessments to the point that each will fall into a category where FCA would have authority to set their rates.

I think the very practical situation we face is that the System has a significant overall capital adequacy problem, which means, based on the regs that Mr. Naylor has referred to, that everybody is in a position of insufficient capital adequacy to set their own rates again, and we're back in the same problem that we have before those regulations were promulgated in the first place.

So, I just want the record to show that the System does not concur that those capital adequacy regs address the issue at all.

Senator HAWKINS. Senator Cochran.

Senator COCHRAN. I realize that there have been times when I haven't been here when other Senators have asked questions, and I don't know whether this question has been asked or not, but is there a strategy—and I ask this of both witnesses—for bringing down the interst rates?

You talk about the options that are available and the alternatives that are being considered. Are we going to continue to see the Farm Credit System and the Farm Credit Administration consider and consider and study and study and not do anything.

That's the impression that I have of what's been going on.

Mr. BEESLEY. May I speak first, Senator Cochran?

I believe the essence of the difference between Chairman Naylor and the System is that we believe interest rates should be reduced today. And that that issue is unrelated to the other efforts that we're making to preserve the System.

Interest rates should be reduced; we should be competitive. Then we should go about, and simultaneously—I don't mean to say one should be done immediately before or after the other—we need to reduce our nonearning assets. Nobody argues with that.

We need to reduce the cost of our debt; that has to be done. But regardless of what occurs there, we have to be competitive.

We don't tie interest rates to our internal situation. We tie interest rates to what's going on in the economy around us. And I think that's the essence of what we're quibbling about here.

Mr. NAYLOR. Senator, I think the direct answer to your question is no, the System does not have a coordinated effort underway to reduce its high priced debt, and that the agency, as its regulator, feels very strongly that it must do so without further delay.

With regard to the issue of specific interest rates, we have no desire to set specific interest rates. We are concerned that the System, if it does that in an unregulated environment, without adequate capital adequacy regulations in place, will very quickly dissipate its resources, and have no means of stemming that off, if it's done in an irresponsible fashion.

And that is the essence of our disagreement, not with regard to setting individual rates, but to protect the interest of individual borrowers, their B-stock, which feel very stongly needs to be protected, their investment in their System needs to be protected, and without proper regulatory authority in place, or the ability to maintain it, that simply can't be done.

And either the Congress or some other institution—and I don't know where else it would be—is ultimately going to have to be, and perhaps very quickly if it's done irresponsibly, faced with having to come back to this table again.

Senator COCHRAN. Well, is what we're really talking about the inevitability of a Federal infusion of funds into the System, and if that is correct, when do you anticipate that will be needed, and to what extent?

Mr. NAYLOR. Senator, I do not believe that if we manage our System responsibly, and I believe we have the capacity to do a great deal on our own behalf.

But the answer to your question is that the two most serious problems in responsibly dealing with that issue is the handling of

the exceedingly high cost debt that the Land Bank System is experiencing; and significantly greater and more aggressive attention, which is to the producers' benefit, in dealing also with nonaccrual loans.

Senator COCHRAN. Mr. Beesley, what is your answer to that question about the inevitability of a Federal infusion of funds, and if that is inevitable, when is it going to be needed, and at what level of support?

Mr. BEESLEY. Senator Cochran, we believe that it will be inevitable unless the System is able to manage itself, its interest rates, and the other aspects that are contained in the business plan.

We have a hard time understanding how the Chairman of FCA knows what we have and haven't done with regard to attempts to restructure our debt.

That has to be done also. We have to deal with our nonaccruing assets.

We, at this point in time, believe that there is a reasonable possibility that the System can work out of its problems without Federal financial assistance if we have the ability to manage, as I have described.

Senator COCHRAN. Madam Chairman, I know that that was the second bell for a vote on the floor, and we both must go vote.

I know that Senator Boschwitz went over to vote early and was going to come back so the hearing could continue, but I understand further, and you may have word about this, that we don't have permission to meet past the hour of 12:30.

Senator HAWKINS. That's correct.

Senator COCHRAN. So, given those constraints, I'm going to ask to place in the record some material here at this point, and then suggest that we go vote, and if Senator Boschwitz wants to come back to continue the hearing to 12:30 he may be permitted to do that. But what I'm placing in the record, Madam Chairman, is a rebuttal to a three-page document that came to my attention this morning which purports to criticize in some detail the bill which I introduced, S. 2770. There's no indication about who prepared this or where it came from. So I make no assumption about that. But I do have a prepared response to each of the criticisms of the bill, and I would like to have that included at the appropriate place in the record of the hearing, Madam Chairman.

Senator HAWKINS. So ordered.

All Senators' statements will be entered in the record, and we would like to have the record held open for inclusion of the specific information that was requested by Senator Boschwitz.

[The material referred to by Senator Cochran follows:]

The proposed legislation would make the following principal changes:

Comment: It would permit individual units of the Farm Credit System to set interest rates at levels which they determine to be competitive with other lenders in their immediate area without regard to their cost of doing business or the cost of funds which they lend or the safety and soundness of their operation.

Response: S.2770/H.R. 5497 will permit the Boards of Directors of the BCs, the FLBs and the FICBs to set their own interest rates without obtaining the prior approval of the Farm Credit Administration, the System's regulator. In setting those rates the Board's would continue to be required by law to take ". . . into account the cost of money to the bank, necessary reserves and expenses of the banks. . . ." (See Sec. 1.7, Sec. 2.4 & Sec. 3.10 (a) of the Farm Credit Act). In addition, the policy statement included in the legislation states that it is the policy of the Congress that

interest rates be based " . . . on the marginal cost of funds, taking into account the credit-worthiness of borrowers and cost of servicing loans."

Nothing in this legislation diminishes the basic fiduciary responsibility of the Boards of Directors of each institution. They must continue to operate the business in a safe and sound manner. Boards must continue to operate their banks in such a manner as to maintain adequate levels of capital and reserves—levels which will continue to be set by FCA. To say that this legislation would encourage banks to operate in an unsafe and unsound manner is ludicrous.

Comment: It will permit poorly managed units within the System which are already in a difficult financial position to incur additional operating losses from failing to charge adequate rates for costs.

Response: This legislation retains FCA's direct authority to take regulatory action against a director or officer whom they believe has engaged in any activity that would constitute a breach of the fiduciary duty of that individual. In addition, FCA retains its authority to issue a cease and desist order against any System institution operating in an unsafe or unsound manner. What the legislation does is to state plainly that " . . . the establishment of competitive interest rates on the marginal cost of funds, taking into account the credit-worthiness of a borrower and the cost of servicing a loan," shall not by itself constitute an unsafe and unsound practice. This change, however, would not permit any Board to ignore capital adequacy standards set by FCA when they establish interest rates for the institution. Again, the Board has a basic fiduciary responsibility which they cannot ignore. This legislation does not alter that responsibility.

Comment: Well managed and stronger units within the System would be required to dissipate their funds for any losses incurred by poorly managed units.

Response: The Farm Credit Amendments Act of 1985 clearly intended that the surplus funds of all System institutions be available in the System financial self-help effort. This legislation does nothing to alter that. FCA and the Capital Corporation will retain sufficient authority to ensure that poor management practices in any System institution be promptly corrected. (See Sec. 4.28G(15)(C) and Title V, Part C of the Farm Credit Act as amended.) It is the responsibility of FCA and the Capital Corporation to point out poor management practices where they exist. If they neither point them out nor see to it that they are corrected, both FCA and the Capital Corporation should be considered negligent in carrying out their duties. Nothing in S. 2770 or H.R. 5497 would diminish the need for System institutions to be properly managed. In fact quite the opposite is true. Given the responsibility to manage their interest rates, System institutions will have more direct fiduciary responsibility for their performance. This increased responsibility cannot and will not be taken lightly by System directors and officers.

Comment: The capital section of the 1971 Act inserted by the 1985 amendments gives FCA authority identical to other financial regulators. This bill would subject System institutions to far less control in the capital area than its competitors.

Response: No other financial regulator has the direct authority to pre-approve every interest rate change made by every institution they regulate. S. 2770/H.R. 5497 legislation is intended to place the Farm Credit Administration on equal footing with other regulators. This legislation does not disturb the basic authority of FCA to require System institutions to maintain adequate and reasonable levels of capital. FCA will maintain that enforcement tool and the powers they need to see to it that System institutions abide by the capital requirements FCA establishes. The changes S. 2770/H.R. 5497 make to FCA's authority to regulate capital levels is very specific. Current law provides that if a System institution fails to maintain capital at the required level, FCA may require that institution to adhere to a specific plan which describes the means by which that institution will achieve adequate capital levels. Under current law as a part of this plan, FCA could require the offending institution to set its interest rates at a level completely unrelated to levels that would be either competitive or reasonable. S. 2770/H.R. 5497 simply state that as a part of the plan to achieve adequate capital levels FCA ". . . may not require the institution to charge interest rates to eligible borrowers that exceed rates generally available to such borrowers from other commercial lenders. . . ." If FCA determined that a System institution were undercutting the market and its capital levels did not meet the minimum required, then FCA could require the institution to take every appropriate action to achieve minimum capital levels including raising its rates to bring them in line with the competition. Under S. 2770/H.R. 5497 FCA would no longer be permitted to require the offending institution to restore its capital by charging rates higher than those generally available.

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Comment: It prevents the Farm Credit Administration from requiring safe and sound operations or requiring adequate capital to sustain the various banks and associations as sound financial institutions.

Response: Nothing in S. 2770/H.R. 5497 ". . . prevents the Farm Credit Administration from requiring safe and sound operations or requiring adequate capital . . ." FCA will continue to have the power to set both (Sec. 4.3(a) Farm Credit Act). Simply put, S. 2770/H.R. 5497 states that FCA may not require System institutions to specifically set interest rates above competitive levels in order to achieve certain capital levels. The decision as to what constitutes "adequate capital levels" is left with the regulator. The decision to raise rates to achieve a specific capital level would be left to the individual board to make rather than the regulator. That is where that decision belongs.

Comment: It accelerates the rate of depletion of the System's funds and commits Congress to an open ended multi-billion dollar assistance or to let the System fail.

Response: System capital declines every time a borrower pays off their loan and leaves the System. The dramatic exodus of borrowers from the System—due primarily to concern over their stock and the frustration over continued high rates—is having a major negative effect on the System. This legislation is aimed at preventing this loan run off by giving the System the opportunity to price its loans to farmers on a competitive basis. It in no way commits the Congress to a "multi-billion dollar" assistance package. The Farm Credit Amendments Act of 1985 made financial assistance contingent upon a specific appropriation by the Congress. Only those funds the Congress chooses to make available will be used to help the System. If the Congress determines that the System has not prudently conducted its business, the Congress won't have to give the System one cent. This legislation does not commit the Congress to spending anything on the Farm Credit System.

In fact it is entirely likely that reducing rates and keeping a larger pool of performing loans in the System will serve to reduce the amount of assistance the System may one day need.

Comment: The bill would create a nationwide non-bank bank which would be virtually unregulated in the financial area.

Response: This bill creates no new banking institution of any sort. All System institutions remain separate corporate entities as they are today and any consolidation of System institutions would continue to require stockholder approval. No authority is provided to permit the mergers of unlike institutions, i.e. a land bank with a bank for cooperatives. To say that this legislation creates one bank out of the System is ludicrous. Even with this legislation the System will remain highly regulated with FCA retaining powers equal to or greater than many of its sister financial regulatory institutions (note attachment A which lists FCA's regulatory and pre-approval authorities).

BACKGROUND

Comment: The Farm Credit Administration believes sound banks should set their own interest rates. The proposed capital adequacy regulations which are now out for public comment parallel the Office of the Comptroller and other regulator's procedures concerning the setting of interest rates. These regulations would permit financially well managed banks to set their own rates and provide for intervention only when an unsoundly operated bank puts itself or others at risk.

S. 2770 would not permit these basic safety regulations to be put into effect.

Response: Proposed capital adequacy regulations would provide some degree of latitude for the well capitalized System institutions to set interest rates. But there remain significant problems with these regulations. For instance, even though a System institution is well managed, if its capital is reduced as the result of assessments for System self-help that institution will lose any flexibility in the setting of its interest rates. That authority will revert to FCA. It appears that by the time these regulations go into force, very few if any institutions would qualify to set their own rates under the proposed FCA regulations. The Office of the Comptroller and the other financial regulators do not have the authority to pre-approve interest rates. They, therefore, have no procedures similar to those of FCA. What they do have is the authority to require that certain capital levels be maintained. S. 2770/H.R. 5497 maintain FCA's basic authority to establish capital levels for System institutions. (See further explanation under item D above.)

Comment: The Farm Credit Administration is not holding the System back from lowering its interest rates. There are two basic reasons why the Federal Land Banks rates have continued at or only slightly below their present average levels.

There are $8.08 billion of nonaccrual loans in the Land Bank System. None of the banks have to date mounted a fully effective program to work with producers to restructure or otherwise rework their loans so that a producer would be able to make some improvement with regard to his status and the banks would receive at least some income from these nonperforming loans.

S. 2770 will remove any incentive for banks to pursue restructured programs aggressively to help troubled producers.

Response: First the figure cited—$8.08 billion of nonaccrual loans in the Land Banks System—is inaccurate. As of June 30 (the last date for which System-wide data is available) nonaccrual loans for the entire System stood at $7.588 billion. $6.341 billion of that was in the Land Bank.

All System institutions are now operating under a restructuring policy outlined by the Farm Credit Corporation of America which provides that borrowers will not be foreclosed upon if the cost of restructuring is less than the cost of foreclosures. Likewise, policies have been adopted to guide the management and disposition of acquired property.

S. 2770/H.R. 5497 will not remove any incentive to pursue restructurings. Existing restructuring policies would not be affected and the System will continue to aggressively seek to assist borrowers.

Comment: The System from 1978 through 1981 made a management decision to expand its market share in many districts. This action required new money which the System obtained by paying from 12 to more than 17 percent for its securities, some of which will remain on their books until 2005 and from which they remove any call provisions. This money was loaned out at rates in the 11-12 percent range. $18 billion of these securities remain on the System's books. The System has not effectively pursued options to reduce the amount of this high priced debt which should enhance their ability to offer more competitive rates to borrowers.

Response: S. 2770/H.R. 5497 do not remove incentives for the System to aggressively seek ways to lower its cost of funds. In fact it can be argued that the opposite effect would result. With System directors and officers having the authority to pass improvements in the System's cost of funds quickly through to borrowers, without having to await FCA approval for every change in the rates, the incentive to bring down the System's cost of funds will increase not decrease. With this legislation in place System leadership could quickly pass on any positive benefits to borrowers. Under current law System directors and officers can only demonstrate directly that they have effectively brought down their cost of funds if FCA decides to let them do so by approving an interest rate reduction. That makes for little or no incentive whatsoever.

Comment: S. 2770 has the effect of reversing much of the progress of the 1985 amendments. It eliminates the authority Congress gave to FCA to require safe and sound banking practices. It was the failure of the System to observe sound operating and management practices that created most of its present crisis.

Response: S. 2770/H.R. 5497 would continue current law which requires the directors and officers to operate their institutions in a safe and sound manner. FCA will retain more than adequate authority to act against a System institution if that becomes necessary.

S. 2770 specifically will have the following adverse effects.

Comment: It prevents FCA from requiring banks to maintain adequate capital for safe operations.

Response: The basic FCA authority to require System institutions to maintain adequate capital levels (Sec. 4.3(a)) is not amended by S. 2770/H.R. 5497.

Comment: It permits management of individual units to set interest rates without regard to their cost of doing business or cost of money.

Response: S. 2770/H.R. 5497 maintain language in the act which guides the interest rate setting policies of System institutions and states that rates are to be set ". . . on a sound business basis, taking into account the cost of money to the bank, necessary reserves and expenses of the bank . . ." (Sec. 1.7, Sec. 2.4, Sec. 2.15(b), Sec. 3.10(a))

Comment: It encourages poor managers to engage in unsound and unsafe operations at the expense of well run and strong banks.

Response: FCA and the Capital Corporation retain the authority to act against poor managers and to refuse to provide financial assistance if poor management practices are not changed (Sec. 4.28G(15)(C)).

Comment: It ensures that the System will exhaust its resources quickly without having made an effective effort to work out their problems as Congress intended with the passage of the 1985 amendments.

Response: System institutions have committed about $1 billion to directly assisting the institutions experiencing the most stress. System loan loss reserves are now $3.463 billion. That hardly depicts a lack of commitment on the part of the System towards using its resources. The continued disastrous economic conditions in the agricultural sector is what will primarily drive the System's need for outside financial assistance.

Comment: Passage of S. 2770 will lead to the System exhausting its funds. In so doing, Congress has committed itself with no limit as to amount or the time such assistance would continue (a major issue last fall) to funding substantial System operating losses or to allow it to fail. If assistance is rendered, this legislation becomes a multi-billion dollar, long-tem assistance package which will cost a minimum of $1.2 billion in the first year.

Response: Passsage of S. 2770/H.R. 5497 will not directly result in the System exhausting its remaining reserves. The continued disastrous economic conditions in agriculture will do that. The Farm Credit Amendments Act of 1985 specifically provide that Federal financial assistance through the Capital Corporation cannot expand after December 31, 1990. Further, no direct Federal financial assistance will be forthcoming to the System without those funds first being appropriated by the Congress. It will be Congress and the Administration that decide when, whether and how many Federal dollars will be available to assist the System. This legislation does nothing to change this procedure.

Comment: Unlike other financial institutions, evey bank in the Farm Credit System is fully, jointly severally liable for the debts of all other units. Without FCA having the authority to intervene in behalf of the System, poorly managed institutions can quickly exhaust the resources of well run institutions and their members. S. 2770 eliminates FCA's authority to continue to serve in this fundamental role to protect the interest of the System's members.

Response: Nothing in this legislation requires FCA to look the other way if a System institution is being poorly managed. The explicit authority they will retain has already been described. In addition, the Capital Corporation has the authority to refuse to provide financial assistance to a Sytem institution if they so choose. That will remain an protection for contributing banks against the continuation of poor management practices.

Comment: S. 2770 gives full protection to directors and managers who maintain unsafe and unsound practices. By allowing banks to set interest rates without regard to their operating costs, costs of funds or other poor management actions, this bill removes any incentive to operate these institutions in a businesslike manner. Corrective action to ensure that the events leading to the current crisis will no longer be possible.

Response: Regarding "unsafe and unsound practices" the only change S. 2770/H.R. 5497 makes is to state that the establishment of competitive interest rates based on the marginal cost of funds taking into account the credit-worthiness of a borrower and the cost of servicing a loan . . ." shall not, by itself, be considered an unsafe or unsound practice. FCA retains more than sufficient authority to require institutions to operate in a businesslike manner. It appears that FCA believes that if System rates are set high enough, the System can weather through without financial assistance—never mind what impact this might have on the System's borrowers.

Comment: GAO, in a current report, has indentified poor and incorrect pricing practices in the setting of interest rates without proper supervision by FCA as one of the most fundamental and critical reasons for the present Farm Credit System.

Response: The GAO not recently issued a formal report dealing with "poor and incorrect pricing practices" of System institutions. A draft report on the financial condition has recently been circulated which is critical of past practives of both the System and FCA. It would be inappropriate to comment further on this report until it is finalized.

SUMMARY

Comment: Though intended to provide interest rate flexibility to FCS banks, S. 2770 will have a far more dramatic and adverse effect on the System. S. 2770 essentially removes the FCA from regulation on the basis of safety and soundness and creates a nationwide nonbank bank without the regulatory restraint imposed on other financial institutions. System banks would be able to reduce interest rates without regard to their cost of funds. If that occurs, System capital could be rapidly dissipated, possibly precipitating a long-term, open ended commitment for Federal subsidies to the Farm Credit System. Finally, S. 2770 will have major long term

budget impact without taking the corrective action to ensure sound future operations and effective service to meet producer needs for agricultural credit.

Response: This paper being distributed by the Farm Credit Administration is replete with factual error and inuendo which inaccurately portrays the intent and end result of S. 2770 and H.R. 5497. It will have no direct budgetary impact nor commit the Federal government to any direct financial assistance to the Farm Credit System. It is unfortunate that the Farm Credit Administration has decided to address this important issue in such a cavalier fashion.

Senator HAWKINS. At this point, we'll stand in recess while Senator Cochran and Senator Hawkins vote. Senator Leahy had requested answers to questions. I also have some additional questions for the record.

Senator COCHRAN. Madam Chairman, I would like to be able to submit written questions, too, along with the others.

Senator HAWKINS. Senator Cochran's questions, also. And when Senator Boschwitz comes back, I'll let him chair. So you all stand by in recess for a moment.

[Short recess.]

Senator BOSCHWITZ [presiding]. The hearing will come to order.

I want to just repeat some of my requests, please. I would like to know what the present capital of the Farm Credit System is by district. I'd like to know it as of the 30th of June, which I presume is the most recent figure. The first of the year; and then, if you would compare it, if you have the figures for the first of the year, 1985, 1984, and 1983.[4]

Mr. NAYLOR. Senator, those data were not kept that way by the System, and such a comparison could not be done. I think the 12-30 to 6-30 comparison can be made, but the Agency has been unable to accomplish that in data that the System's been able to provide.

We made a similar request to the System before and they simply have not kept data in a fashion which would permit that.

Senator BOSCHWITZ. What do you mean, Mr. Beesley, you don't provide any net worth of the System by district?

Mr. NAYLOR. No, evaluation on a comparable accounting basis for the last 3 years.

Mr. BEESLEY. Mr. Chairman, FCA established the accounting rules for the System up until the 1985 amendments, at which time this Congress required this System to go to generally accepted accounting principles. That resulted in a major change in accounting, which makes 1985 data on a different accounting system.

We can give you numbers for 1983 and 1984, but it's not directly comparable to the numbers from 1985 and forward.

Senator BOSCHWITZ. The definition of net worth changed?

Mr. BEESLEY. The definition of net worth changed in that the components changed. For example, allowance for loan losses were taken out of net worth, and established as a reserve as of the end of 1985 for the first time.

So that was a major factor in the enormous losses——

Senator BOSCHWITZ. You mean that the bad debt reserve was included in capital?

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[4] The information requested by Senator Boschwitz was received and has been retained in the committee files.

Mr. BEESLEY. There was no bad debt reserve under accounting established by FCA.

Senator BOSCHWITZ. Well, just give it to me then for the first of the year, and the 30th of June because those sound like more realistic figures.

You can do it, please, by district. Then once again I would like to have the earned capital, and the paid in capital, so that I can get a sense of what it is.

Also, perhaps we should have the bad debt reserve for each district in that case.

Mr. BEESLEY. That's easily provided, all of that.

Senator BOSCHWITZ. For the 1st of January and the 30th of June.

Then I asked for the list of your inventory of notes, bonds, securities. I don't know who to ask, if it's you, Mr. Beesley, or Mr. Naylor.

Mr. NAYLOR. I believe we have a current list. And we'll advise you as soon as I can check on it.

Senator BOSCHWITZ. Yes. And I may ask you gentlemen to get together again because I would like to take a look at that inventory pretty quickly, because if the inventory, the amount you're paying for the money is very high, that in my judgment leaves us fewer options.

Also, if you would, just a statement with respect to the billion dollars of property that one of you gentlemen spoke about that you own and how it's accounted for so that I can get a relationship of your net worth to how you have valued property that you hold and taken back.

Mr. BEESLEY. Senator, I can give you a few things on that for the record right now if you like.

That property is carried at its market value, or our best estimate of what its market value is. We currently have 4,693 farms; we have acquired since the end of 1985, 2,224, and we have sold 2,389.

And it is carried at its estimated market value.

Senator BOSCHWITZ. And if you would in that paragraph that you describe the billion dollars, why don't you tell me what you have marked that down? Is $1 billion the present value? Or was it the value of the loans?

Mr. BEESLEY. Substantially less than the values of the loans that were incurred.

Senator BOSCHWITZ. And that has already been taken off your net worth?

Mr. BEESLEY. That is correct.

Senator BOSCHWITZ. Mr. Naylor mentioned $800 million as the cost of doing business. That's of all the PCA's, all 448 of these organizations?

Mr. NAYLOR. That's the entire System's administrative overhead.

Senator BOSCHWITZ. That's about 1.2 percent of $65 billion.

Mr. NAYLOR. It is higher than the commercial banking industry finds is an acceptable margin for business, by quite a bit.

Senator BOSCHWITZ. I was on a bank board, but that was 10 years ago, and I forget exactly what the cost of doing business is. Perhaps Mr. Beesley—you were with the FSLIC?

Mr. BEESLEY. Yes. Mr. Chairman, on this point, Mr. Naylor and I are in total agreement, as we are, frankly, in most of the issues facing the System today.

We believe that the costs and overhead structure of the System are way out of line. Part of this is the result of the fact that volume has reduced, or decreased substantially and we have not been able to downsize our operations.

Senator BOSCHWITZ. What do you mean you haven't been able to downsize them?

Mr. BEESLEY. Well, we haven't been able to close branches. The Farm Credit System has more outlets than the sum of the world's five largest banks. We need to reduce our overhead.

Senator BOSCHWITZ. You can't count outlets. What does a normal savings and loan bank—what's its cost of doing business as a percentage of its assets?

Mr. BEESLEY. A well run bank would be in the neighborhood of 150 basis points. But that is not a good indicator, because a large percentage of that is used to gather deposits. And to maintain a branch network for the purpose of garnering deposits, which we don't have to do.

Senator BOSCHWITZ. You just told me you had more branches than the five largest——

Mr. BEESLEY. Yes, but we don't take deposits in those.

Senator BOSCHWITZ. I don't believe that, incidentally. Citibank has an office in every burg.

Mr. BEESLEY. We have more branches than all five of the world's largest banks. You can find that in the American Banker.

Senator BOSCHWITZ. They're wrong. I mean, you take some of these British banks, or these Canadian banks, they've got more branches than Carter's got little liver pills.

Mr. BEESLEY. We have——

Senator BOSCHWITZ. Citibank has several branches in Minneapolis, for goodness sake. I can't believe that to be the case.

Mr. BEESLEY. We are very concerned about our overhead, and if you look at our business plan, one of the five major short-term objectives that we have established is to streamline our overhead and eliminate costs.

But that is not going to save the Farm Credit System alone.

Senator BOSCHWITZ. So you're doing it for 120 basis points, and you say an ordinary bank does it for 150, but ordinary banks spend a lot of money getting deposits? What's the difference where it spends its money for overhead? What should you be doing?

Mr. BEESLEY. We believe that the target should be around 60 basis points. Between 60 and 70.

Senator BOSCHWITZ. Yes?

Mr. BEESLEY. We would like to cut our overhead in half.

Mr. NAYLOR. Particularly for real estate lending, Senator. The margin is too wide.

Mr. BEESLEY. And in the short-term side, in the PCA side, we're almost up to 400 basis points. The land bank is down to near 60 already.

Senator BOSCHWITZ. Well, 400 is certainly very high. And have I also asked for the volume of the System by district?

Mr. NAYLOR. I don't believe so, Senator, but we will provide it.

Senator BOSCHWITZ. OK, 6-30, 1-1. Now, I presume that you can provide that for 1985, 1984, and 1983?

Mr. NAYLOR. Volume, yes.

Senator BOSCHWITZ. Volume would not be difficult.

Mr. BEESLEY. Mr. Chairman, we can, if you would like, provide all of that information that you asked, our forecasts up through 1988 as well, not only the past but the future.

Senator BOSCHWITZ. Fine. I really want to deal in not so much the past as I want to deal with the numbers that you're confronted with.

Most importantly, what Senator Melcher was talking about, your inventory of securities, and whether or not you really can make changes. I mean, I don't know how you could buy back your debt—if I were holding one of your securities at 15 percent, payable in the year 2000, you would have a hard time getting me off that.

Mr. BEESLEY. Well, the cost of buying back our debt today exceeds $4 billion. There's no free lunch.

Senator BOSCHWITZ. If you can buy your debt back for $4 billion, that may be cheap.

And then if you can go out and borrow for an average of 7, and then if you can do business for 60 basis points, you can be loaning out money at 7½, and you can come in here and sit as heros.

Mr. BEESLEY. The numbers work out that whether you buy it back or whether you don't buy it back it's a wash, because the investor has to take the money you buy back and reinvest it.

The question is one of timing. The strategies that we're exploring would allow us to buy it back and perhaps increase our costs down the road. For example, if we save 300 or 400 basis points over the next 2 or 3 years, then we're going to have to increase our costs by 50 basis points for the next 15 years. So there is no way of manipulating these numbers so it becomes a free lunch.

Senator BOSCHWITZ. Oh, I quite understand that. And I would like to look at that.

I might say just as a comment that the Capital Corporation seems to be taking off a good deal slower than we had hoped here on the committee. The idea of warehousing some of the poorly performing loans, I don't think any of that has occurred yet, to the best of my knowledge.

Mr. NAYLOR. No, Senator, they did get off to a much slower start than we had hoped, although I would say to you that it's one of our bright spots, we feel, in the sense that the Capital Corporation is finally beginning to address its responsibilities and to the extent that continues that will be very constructive.

Senator BOSCHWITZ. That was an interesting part of your testimony, Mr. Beesley, that all of the districts seem to be in concurrence with respect to that. That would indeed be very helpful.

I think it would be very helpful to becoming competitive again. Because as I look at the Farm Credit System, and then I look at the rural areas, where interest rates still are higher than they are in town, where I borrow, I see the Farm Credit System kind of holding an umbrella over interest rates. Because they're high, the local banker says why do I have to be three quarters of a percent over prime, which is what I borrow for, in Minneapolis. But if I were out in Nuell, MN, or in some of the other towns where the

Farm Credit System is three or four points over prime, the local bank says, I don't have to be three points under them; I have to be a half point under them. So that the Farm Credit System is holding up the whole cost of borrowing money in rural America. And hopefully by looking at some of the numbers, we'll be able to get a better sense of whether or not anything can be done about it.

What would happen if we began, if you had to look to the capital that is paid in by the farmers? Would you expect in that instance--you know, you talk about $10 billion worth of reserves. That's a pretty good reserve, three and a half billion of loan loss reserve that has not yet been invaded. Two billion or so in capital; and then four and a half billion in paid in capital.

Mr. NAYLOR. I believe the number is 4.6, Senator.

Senator BOSCHWITZ. 4.6 billion in paid-in capital. What happens to the System if you begin to call in that, or freeze that, or do something else?

Mr. BEESLEY. I don't think anyone knows exactly what will happen, Senator, but we're concerned that qualified borrowers with other options for credit will seek those options out, as opposed to putting their capital into that kind of jeopardy. We believe that will have a negative impact on loan volume, which will have a further negative impact on our cost of funds. Any borrower can come in and pay off their loan and take their capital.

Senator BOSCHWITZ. There's no prepayment penalty in the Farm Credit System?

Mr. NAYLOR. No.

Mr. BEESLEY. Well, there is on loans that are being written today, but there isn't on loans that were written years ago. But we are concerned that if borrower stock is impaired that there will be further pressure on our loan volume, and further pressure on good borrowers to leave the System.

But nobody knows for sure what the total impact of that may be.

Mr. NAYLOR. Senator, it is a very difficult issue. By and large, historically, the borrowers have been assured that they will get their stock back, and I would agree with Mr. Beesley, it's uncertain unless that issue was addressed with great care and assurances of some sort, it would be very difficult to forecast what the effect would be if you had an actual impairment. Occasionally there have been technical impairments, but to have an actual impairment, the impact on volume and on future customers is very unpredictable at this moment.

Senator BOSCHWITZ. I would agree with that.

Do you believe, if each one of you gentlemen would answer, whether or not you will be back here asking for some type of Federal capital participation in the FCS, call it what you will, bail out, so forth, guarantee, or purchase of FCS securities, for the purpose of providing capital? Do you believe that within the next 6 months or 12 or 18 months you will be back before us?

Mr. BEESLEY. Senator, as you know, the health of the Farm Credit System is, to a large degree, a function of the health of the overall agricultural economy. If I have the luxury of some optimistic assumptions, both as to the health of the agricultural economy and to the ability to hold our loan volume, et cetera, I think that we have a reasonable possibility of making it without that.

But there's also the possibility that we won't. I guess I'll have to give you a very definite "I don't know." I really don't. I think the jury is still out on that issue. We're doing everything we can to avoid and minimize the need for Federal financial assistance.

It is a possibility, a real possibility that we'll be back. We're going to do everything we can to avoid it.

Mr. NAYLOR. Senator, I think the quickest answer is at this point we don't think it's necessary. But I, frankly, don't have the final answer on that, because it depends so substantially both on the economy, but perhaps more importantly on what the System does itself to timely and effectively use its resources.

For example, if the current proposed legislation were passed and used imprudently, it would have a very dramatic effect on the System's resources, and change the equation substantially.

It's just unclear at this point. I know Treasury and ourselves will monitor, and are monitoring their situation very closely, and whether or not real progress is being made on, in our view, the two key issues, the high cost of debt, and the nonaccrual problem, which if not corrected is very, very damaging to the System.

Senator BOSCHWITZ. I want to ask a question, and then I'll make a short statement. Mr. Beesley, as you've heard, has laid some of the source of his problems on to you. That is, that you're trying to hold up interest rates for the purpose—you know, I'm not pleading capital. And he says that in effect you're going to cause the borrowers to flee, those who can, at least. And that you have said a number of times through the testimony that it's not your intention to do that. And yet Mr. Beesley believes that you are.

I wonder if you would discuss or respond to that. I don't believe you've been asked to directly respond to that.

Mr. NAYLOR. Senator, I think the response basically is this: If the issue is competitiveness, the System has already asked and told us what they needed to be competitive with those borrowers to have the capacity to refinance.

And they've been given that, and the System is offering what the only competition out there is offering, fixed rate loans for 3- or 5-year periods. That's the only competition, Senator, that's out there, from any other lender. And I can show you, and do have for the record, the interest rate programs being offered by districts throughout the System, and with the interest rate spreads they've already got, and if they use them effectively, they are in a position to be fully competitive.

Senator BOSCHWITZ. Is that in the record?

Mr. NAYLOR. Yes, for some districts, but not all. But I will provide the whole piece for the entire System.

Senator BOSCHWITZ. Why don't you do that.[5]

Mr. NAYLOR. Our problem is a very simple one in the respect that if you allow the System to operate as an unregulated nonbank bank, and to set its interest rates with total disregard to its overhead and to its cost of funds, then you're going to incur very substantial losses that either Congress or the System and its borrowers will have to pay for.

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[5] The information requested by Senator Boschwitz has been retained in the committee files.

The interest rate reductions that are in place, which permit them to be competitive, and, indeed, the interest rates indicate that to be the case, that they have that capacity, on the borrowers that can refinance, that are the ones we're concerned with, is already in place.

We do not want and are not setting specific individual interest rates. We are very much concerned about safety and soundness; we are very much concerned about protecting strong banks from having weak or poorly managed banks dissipating not only their own resources, but those of the strong banks through irresponsible pricing actions. And, indeed, I think a number of independent reviews will give very strong voice to that same concern.

Senator BOSCHWITZ. Mr. Beesley, how do you respond?

Mr. BEESLEY. Chairman Naylor refers to "if the System prices irresponsibly," if we do this or that. The facts of the matter are the average rate at the Federal land banks are 12.2. The average rate at the PCA's for the first half of the year are 11.3. And at the Bank for Cooperatives, 10.08. Total average loan rate is over 11.73.

The one and only reason our rates aren't competitive today is that the Farm Credit Administration has not given us the ability to set our rates the way we think they should be set. It's an issue of who's going to decide this, and it's basically the only real issue, I think, that divides the System from its regulator.

It's the question of who is going to be accountable, who is going to be responsible, and who is going to manage interest rates in the System.

Senator BOSCHWITZ. What is the average cost of all of your funds?

Mr. BEESLEY. Average cost of funds today is 9.74 percent.

Senator BOSCHWITZ. Of your entire inventory?

Mr. BEESLEY. That is correct.

Mr. NAYLOR. Senator, two-thirds of their business, and that's where the real problem is, in the land bank, the average cost of funds is 10.69. And it costs them 100, 150 basis points on top of that for their cost of doing business. And so you're looking at a cost of business that exceeds what they are charging currently today for interest rates. And indeed, they are negatively pricing today and to the extent that it is $200 million of losses created by the current interest rate levels they're operating at, it would be a billion two if you brought down or had a free-fall of interest rates without regard to cost.

I must take exception with Mr. Beesley. It is not FCA that is holding up interest rates. It is $18 billion of very expensive debt that the System management incurred without a call provision, and hasn't been able to effectively deal with.

It is $8 billion of nonaccrual loans which the borrowers who are having those problems have not been seen, loans have not been restructured; they have not been reworked, or some action taken to begin to put them back on a paying basis again.

That's what's holding the interest rate cost up. We have no desire to set specific interest rates. I would have no objection to section 3, for example, of Mr. Cochran's bill. I do have very strong objections to allowing bank management to have a free hand to arbitrarily, without regard to their total business perspective, their cost

of doing business or cost of funds, simply arbitrarily setting rates wherever they feel is appropriate.

The history of the System would show—and I think that is backed up by other reviews—that one of the major, if not the major reason the System currently faces its problems, was inappropriate and wrong pricing on the part of management without the regulator intervening to insist that adequate capital was maintained over the last 5 to 10 years.

Senator BOSCHWITZ. Let me comment on that for just a moment by saying that I'm not quite as critical of the Farm Credit System as perhaps some other people are. I know they were out there hawking their money back in the 1970's, and convincing a lot of farmers to sign on the bottom line, and so the farmers took the risk and so forth.

But the same time that the Farm Credit System was getting involved in a lot of not very classy loans—I mean, the regulated banks, they were not exactly shining through. I'd rather have loans for these farmers than with Brazil or with the Sudan or with some of these other countries that they loaned money to in recirculating to so called petrodollars. So that whether or not they're regulated doesn't seem to always lead to very responsible type of lending. And I think that by and large—as I look at the Farm Credit System, at least there's land there. By and large. I mean, some of the PCA's, of course, are not so guaranteed. And there is some intrinsic value that is not found behind a number of other loans. And, frankly, the borrowers are not in the same position as a country is with respect to its loans. It doesn't have all the same options, particularly when its assets, the borrowers of the Farm Credit System, their assets can be seized far more easily, for instance, than the assets of Mexico, if there are any. Of course there are. I don't mean to suggest—have the Mexican Ambassador come up here. That's not a visit that I would relish.

But in any event, I would like to take a look—you say 9.47 percent. And you, Mr. Naylor, say that the cost of money in the land bank is 10.7. And that the cost of doing business is 0.6. So that——

Mr. NAYLOR. That's the objective, Senator. The cost is closer to 100 or 150 basis points.

Senator BOSCHWITZ. Well, but the cost of the PCA is where the costs are so high.

Mr. NAYLOR. Well, it's in the land bank also.

Senator BOSCHWITZ. 0.60 you said for the land bank.

Mr. NAYLOR. That was their objective.

Mr. BEESLEY. No, it is approximately 0.60 in the land bank side alone.

Senator BOSCHWITZ. And 400 basis points in the PCA's.

Mr. BEESLEY. And that brings us up to the aggregate of what Mr. Naylor said.

Senator BOSCHWITZ. So it's 0.7, 0.8 in the land bank. A tenth of a point you can deal with 0.1. But four points in the PCA's. You may have to undertake some horrible reductions in the PCA overhead, if it can be done. I mean, they're sitting in some pretty good looking buildings, and some of their overheads may be fixed.

I had the same problems in my business; I had a few Taj Mahal's sitting around. What can you do? You have to just cope with them as best you can.

But, I would like to take a look at what my friend, Senator Melcher, calls your horrible inventory, and then figure out a way, if there is a way, to get out from underneath that. And maybe there is some way to find a way out.

Mr. BEESLEY. May I make a point, Senator? Our losses for the first 6 months of 1986 were $986 million. Now, that figure is very interesting, because it equals approximately the contribution we made to our allowance for loan losses. It also equals the approximate amount of the excess interest we're paying on our high cost debt.

The $986 million loss for the first half of the year approximates the contribution to allowance for loan losses, and also is approximately equal to the excess interest we paid. Or, said another way, if only one of those two things had occurred, we would not be in the tremendous problems we have today.

But both of them came simultaneously. We had a precipitous drop in interest rates, unparalleled in economic history, and we also had a precipitous decline in the quality——

Senator BOSCHWITZ. A precipitous drop in your competitor's interest rates.

Mr. BEESLEY. Well, in the overall level of interest rates, which made our cost of debt so high relative to the marginal cost of debt.

Senator BOSCHWITZ. But are you saying that you lost a billion dollars on the interest rates?

Mr. BEESLEY. We lost approximately a billion dollars in the first 6 months as a result of excess interest rates we had to pay relative to what the market rates for new debt would have been.

We also lost a billion dollars——

Senator BOSCHWITZ. However, you didn't book that.

Mr. BEESLEY. Well, we booked it in that we're paying that interest out every month.

Senator BOSCHWITZ. I understand, but you're charging interest to offset that.

Mr. BEESLEY. Yes, but the point is we have a billion dollar loss as a result of funding errors, or misjudgments. We also have a billion dollar loss as a result of credit problems. Those two coming together wipe out what we would have otherwise made which would have been a billion dollars in profit, and gave us a billion dollars loss.

So, two very, very major factors occurred in the environment that hit the Farm Credit System with a double whammy.

Senator Boschwitz But you only lost a billion dollars, so that you were able to charge a little more while some of your competitors were charging less. You recouped a billion dollars in interest that you might not have otherwise charged, because you only lost a single billion.

Mr. BEESLEY. That's correct. However, we believe that strategy——

Senator BOSCHWITZ. You could have made a billion, so you say you lost two.

Mr. BEESLEY. That's right. That's what I'm saying.

Senator BOSCHWITZ. All right, if I have all those numbers, and I would like to have them by tomorrow, and I suppose other members of the committee should have them as well, I may ask to get together with you two gentlemen again and get some of the staff, and we'll have further informal briefings, probably in my office or somewhere, so I can get a sense of which way to go.

We now adjourn.

[Whereupon, at 12:35 p.m., the committee adjourned, subject to call of the Chair.]

[Written questions from Senator Helms and Mr. Naylor's answers thereto:]

Question 1. Would you comment on the additional enforcement powers granted FCA in last year's legislation—how have they been used? Are additional powers necessary?

Answer 1. The FCA has adopted regulations necessary to implement the enforcement authorities conferred upon the agency in the Farm Credit Amendments Act of 1985. Those regulations deal with matters related to the conduct of investigations, the issuance of subpoenas, the conduct of administrative proceedings and general matters concerning practice before the agency.

The agency has to date exercised its enforcement authority through the issuance of supervisory letters, written agreements and commencement of cease and desist proceedings against banks and associations of the Farm Credit System alleging the existence of unsafe or unsound practices and violations of law and regulations based on examination findings. All of those cases have resulted in the institutions' agreeing to take specific actions to correct the practices alleged. The FCA has also issued orders of investigation.

The FCA notes that the other Federal banking agencies have had considerable experience in dealing with their like enforcement authorities and have made several informal and formal recommendations for congressional action to strengthen the respective statues. The FCA is in communication with those agencies on such matters and may develop its own proposal to seek supplementation of the agency's related authorities.

Question 2. Many Senators—including this one—have heard complaints from System institutions that they have been forced to keep their interest rates non-competitive. Are FCS interest rates competitive?

Answer 2. The System's ability to offer competitive rates in short term lending through the production credit associations (PCAs) is basically competitive with other lenders. This is largely because the FICB/PCA arm of the System has maintained a shorter-term debt portfolio and benefitted from the decline in securities rates in general.

As of a July telephone survey by our Economic Analysis Division, the FLBs continued to be uncompetitive on their average variable rate to borrowers. However, with most of the districts shifting to differential pricing, matched funding and other competitive pricing strategies, the FLBs in many districts should be able to match the competition in keeping their most creditworthy borrowers. Most of these rate reductions and pricing programs were not implemented until September 1, so we do not yet have a good measure of their effectiveness. The FLBs still have problems of an average cost of funds above the prime rate, plus the drag of nonaccrual loans and acquired properties, affecting their average cost of lending.

The FLBs will continue to have a problem of borrower flight and in attracting new borrowers unless they deal with nonaccrual loans more effectively, market their loan programs, and improve borrower relations by showing more of a willingness to work with existing borrowers.

Question 3. What would be the effect on the System's financial position of a 1 point across-the-board reduction in interest rates? 2 points?

Answer 3. If loan interest rates charged on all System loans were reduced 1 percent the System's earnings and capital would be reduced by nearly $600 million *per year.* A 2 percent across-the-board loan rate reduction could reduce System earnings and capital by as much as $1.2 billion *per year.* Both estimates are based on the assumption that the rate reduction would halt the runoff of existing loans but would not stimulate new loan activity. Even though some new loans may be booked if loan interest rates are lowered, the income from these loans would not significantly lessen the massive losses and dissipation of capital that would be caused by an across-the-board rate reduction.

Question 4. How has the ability to grant differential pricing affected the competitiveness of System banks?

Answer 4. Farm Credit Banks that have implemented differential pricing programs are able to offer loan rates that are at or below the average rates charged by major competing lenders operating in the bank's district. For example, one Federal land bank that implemented a differential pricing program offers a 9.50 percent loan rate to financially sound borrowers whose loans pose low credit risks and servicing costs for the bank. This rate is more than 2 percent below the average rate charged by commercial banks located in the land bank's district based on recent statistics from the Federal Reserve. The ability to offer differential rates is a powerful tool for retaining current borrowers and attracting new loans without causing the massive dissipation of capital that results from across-the-board rate reductions. Unfortunately, not all System banks have taken the initiative to implement these innovative pricing programs.

Question 5. What, in your judgment, can System banks do to reduce the impact of the $8 billion in non-accrual loans?

Answer 5. The record levels of non-accrual loans held by System institutions is the most serious impediment to the System regaining its financial viability. It is vital that the System manage this problem in a sound business manner. Congress gave the System an invaluable mechanism for managing the non-accrual loan problem by establishing the Farm Credit System Capital Corporation. The Capital Corporation, if permitted to operate as Congress intended, could bring a great deal of expertise to bear on the management of problem loans.

In addition, for quite some time I have encouraged the System to closely examine each problem loan to determine if it can be restructured in some manner to make it an income earning asset. As long as it is consistent with safety and soundness considerations, loan restructuring can often help some borrowers and may be less costly to the System than foreclosing on the troubled loan. To date, we have seen only limited use of loan restructuring to handle problem loans.

Question 6. It has been suggested that Congress provide a standby appropriation in case System resources should be depleted this year after Congress has adjourned. Do you believe such a step is necessary or prudent this year?

Answer 6. It is the FCA's assessment, based on the System's current reported performance and condition, that an appropriation of Federal funds at this point would be premature. The System, as a whole, still has substantial risk capital. Its reported condition certainly does not require an appropriation for the balance of 1986 or early in 1987 before the 100th Congress would convene. Let me stress that this assessment is based on existing regulatory authorities. If legislation were enacted that allows System institutions to set their interest rates without regard to their overall operating costs or financial condition and removes FCA's authority to establish minimum capital standards, we would have to project substantially larger losses by the System.

Question 7. What corrective actions to ensure future soundness of the System can System institutions take that they have not already taken?

Answer 7. Mr. Chairman, I believe the Farm Credit System could begin to ensure the soundness of its institutions with some basic, fiscally responsible actions that would show their real intent in trying to get a handle on their problems.

First, a systematic approach in dealing with their $800 million overhead for operations is a good place to start.

Second, the System needs to put forth a comprehensive workout plan to reduce the significant volume on non-accrual loans which are paralyzing the System's productivity. I personally believe that the System can not resolve its current difficulties until it gets some activity out of its non-producing loans.

Finally, the System must work to improve borrower relations.

Question 8. Would you explain FCA's capital adequacy regulations, and particularly the four regulatory Zones into which institutions will be placed?

Answer 8. The 1985 Amendments require the FCA to ensure that System institutions maintain adequate capital. At the same time, however, Congress directed the FCA to minimize its involvement in the day-to-day management of the System. The capital adequacy regulations are intended to enable the FCA to meet both of these Congressional mandates. The capital adequacy regulations allow the FCA to focus regulatory attention on those System institutions that are not adequately capitalized and to prevent such institutions from dissipating their remaining capital. On the other hand, the FCA has minimized its involvement in institutions that are stronly capitalized by allowing such institutions to establish interest rate programs, pay dividends to their stockholders, pay patronage refunds to their borrowers, and establish the salary of the chief executive officer subject to a financial plan ap-

proved by the institution's board of directors, and without a requirement to obtain additional approval from the FCA. Such authorities remain in effect as long as the institution maintains a strong capital position and acts responsibly.

The capital adequacy regulations establish numerical capital standards that define four regulatory zones, A through D. The numerical standards were developed based on a financial and statistical analysis of the capital levels of System institutions during the 5 year period 1980 through 1984. Each System institution is classified into one of the four zones based upon the amount of unallocated retained earnings (all earnings retained by the institution that have not been allocated to the institution's stockholders) and total capital (retained earnings plus earnings plus member-owned stock) of the institution. While this classification approach is similar in certain respects to the methodology used by other financial regulators to regulate capital, the unique nature of the Farm Credit System dictates a unique method of regulating the System's capital. As described below, the degree of the FCA's regulatory intervention into the capital-related activities of an institution is directly related to the institution's financial strength and the regulatory zone in which the institution is classified.

Institutions classified in zone A are strongly capitalized and, as such, are not required to obtain FCA approval for, nor are limitations placed upon, the institution's capital-related activities such as the establishment of interest rates, the payment of dividends, and the payment of patronage refunds. These institutions are subject to minimal intervention by the FCA.

Zone B institutions maintain adequate capital but are not as strongly capitalized as institutions in Zone A. A number of restrictions are placed on the capital-related activities of these institutions, such as limitations on the rate paid on dividends and the amount of patronage that may be paid in cash, but the institution is not required to obtain FCA approval for its capital-related activities.

Institutions in Zone C have weak, but not necessarily inadequate, capital levels. More severe restrictions, such as a prohibition on the payment of dividends, are placed on such institutions to conserve their remaining capital. Most Zone C institutions are required to operate in accordance with a financial plan approved by the board of directors and the FCA.

Those institutions classified in Zone D are undercapitalized and have either impaired member-invested capital stock or are dangerously close to doing so. These institutions are subject to strict capital regulation by the FCA. Any action that would further dissipate the capital of the institution, such as payments of dividends and patronage refunds, is prohibited. The institution establishes its interest rates in accordance with a financial plan that must be approved by the FCA. Institutions in Zone D are not eligible to contribute capital to the Capital Corporation since such contributions would further weaken the institution's financial condition.

Question 9. I have heard from some of my friends in the System who feel FCA has overstepped its role as a regulatory agency. How do your activities and powers compare to those of other regulatory agencies?

Answer 9. The regulatory powers of the Farm Credit Administration contained in the Farm Credit Act of 1971, as amended, are comparable to the powers of the other Federal financial institution regulatory agencies. Those powers relate to the examination and regulation of the System institutions, and the power to take appropriate enforcement actions to ensure the safe and sound operations of the System institutions. The FCA does have some additional powers which the Congress has determined are necessary in order to accommodate certain unique aspects of the operations of System institutions. Included within these powers are the power to approve the issuance of obligations by System institutions, and approve the salaries of the Chief Executive Officers of System banks. The Congress has determined that these powers are necessary in order for the FCA to ensure that the operations of System institutions are consistent with law and in accordance with the policy ojectives of the Farm Credit Act of 1971.

The Farm Credit Administration exercises its powers consistent with the directives of Congress, and in a manner consistent with other Federal financial institution regulatory agencies. The Farm Credit Administration is in the process of reviewing its existing regulatory requirements in order to ensure that they are consistent with the agency's status as an arm's-length regulator. Based on this review, the Farm Credit Administration will be eliminating or modifying certain prior approval requirements by providing regulatory approval for classes of activities that comply with specified regulatory standards. These regulatory changes, which will be implemented over a period of time, were specifically encouraged by the Congress during consideration of the 1985 Amendments.

The institutions of the System are currently going through a period of adjustment which may be somewhat difficult in that they are not accustomed to the role of the FCA as an independent arm's-length regulator, but they will undoubtedly adjust over time to dealing with the FCA on issues in a manner which typifies the relationship of other Federal financial regulators to the respective institutions for which they have examination and regulatory responsibilities.

[Written questions from Senator Zorinsky and Mr. Naylor's answers thereto:]

Question 1. Mr. Naylor, you have served in various positions that allowed you the opportunity to follow developments in the Farm Credit System for a number of years.

On the basis of your observations, have you reached any conclusions as to what factors permitted the financial condition of the System, which was long considered one of the most financially sound lending organizations in the world, to rapidly deteriorate in recent years?

Do you believe that the Farm Credit legislation enacted in 1971 was a factor in this regard? If so, how?

Answer 1. Senator Zorinsky, a number of factors have had impact on the Farm Credit System's current financial condition. The pricing mechanism used by the System in developing its interest rate programs has had a severe adverse impact on the System in a down-turning market. This is true not only in terms of interest rates but also the expectations of growth and continued prosperity largerly as the result of the inflationary conditions of the 1970's. Similarly, inadequate credit controls or credit supervision, inadequate management by the System of its loan portfolio, the making of loans without adequate security or assurances for repayment—particularly from a cash flow standpoint, all have been significant factors in the deterioration over recent years. For the most part, System institutions failed to maintain adequate and current financial information on their borrowers and, as a result, were not aware of the deteriorating condition of many of their loans until defaults had occurred. The System also, in the last few years, has had a significant deterioration in some parts of the country in its member/borrower relations for a variety of reasons ranging from loan restructuring proposals that were not popular to the fundamental rapport and treatment members recieved when attempting to deal with problem loans for restructuring and forbearance.

I would also have to add, Senator, that it is my belief that the Farm Credit legislation enacted in 1972 was a significant factor in the development of this deterioration in that it dramatically changed the basis upon which real estate lending could be carried out under the Federal Land Bank System. In particular, the changing of the basic requirement that land secured loans could not be made for more than 65% of the appraised value, to the 1972 legislation of 85% of the appraised value. On the basis of appraised value, of course, value of the land was inflated. During the unrealistic inflationary period, the System was continuing to loan funds, and even increasing its number of loans on real estate well in excess of the agricultural value. When history has a chance to evaluate it, that change may be one of the most significant factors in many of the problems that occurred in the Mid-west over real estate and farm land value, and led to many of the Farm Credit System problems.

Question 2. Mr. Naylor, have the Farm Credit institutions been able to take advantage of the interest rate buy-down program of the Farmers Home Administration to reduce rates on loans of eligible borrowers?

Do you have any recommendations as to how the interest rate buy-down program and the FmHA guaranteed loan program could be better used by System institutions?

Answer 2. Although the System has access to these programs, its participation has been disappointing. It is our view that as long as there are unallocated funds for buy-downs and loan guarantees available through Farmers Home Administration, it is the responsibility of the lender, including Federal land banks and production credit associations, to consider how they might help loans on a case-by-case basis. The System would be in a better position to explain what modifications might increase its use of these programs. We definitely think there can be greater participation.

Question 3. Mr. Naylor, the Farm Credit Banks of Omaha, by letter dated August 12, 1986, from John A. Harling, President, and Leo A. Allmendinger, Chairman of the Eight District Board of Directors set out a detailed list of actions that the banks have taken, or plan to take in the future to improve their financial condition.

Have you reviewed this letter? If so, do you believe that these actions will be sufficient in helping the banks reestablish a profitable operation? Do you have any other

suggestions as to how the banks may improve their operations at this time? If so, have you informed the banks of any such recommendations?

A copy of the letter is attached.

Answer 4. Mr. Harling and Mr. Allmendinger sent the August 12 letter as a courtesy to inform us of actions that had been taken in the Eighth Farm Credit District and to outline their plans to cope with some of the immediate problems facing that district. Although I have reviewed their letter, it would be premature without FCA's on-site examination to determine what actions have taken place and their effectiveness in correcting problems, to make any assessments or recommendations at this point. The focus of FCA's independent examinations, as required by statute, will include the issues they raised. The actions outlined reflected a positive approach to enormous problems within the System and that district.

[Written questions from Senator Leahy and Mr. Naylor's answers thereto:]

Questions 1. What difference would it make to the financial position of the Farm Credit System if some member banks were to reduce interest rates?

Answer 1. The financial crisis that the Farm Credit System currently faces dictates that each System institution do everything possible to conserve its remaining capital. For many borrowers, the Farm Credit System is the only source of credit available. The System's borrowers will pay a high price for a reduction in their loan interest rate if they ultimately lose access to their sole funding source as a result. Massive across-the-board interest rate reductions will hasten the onset of serious financial difficulties and would ensure the need for outside financial assistance. Since all System banks are inextricably tied together financially as a result of the joint and several liability each bank shares on the System's debt instruments, the actions of even a single bank can adversely affect all banks and associations.

Question 2. When do you estimate federal capital might be needed by the FCS under various scenarios—such as maintaining current interest rates, or allowing all system institutions to charge market interest rates?

Answer 2. The Farm Credit Act requires the System to commit its available capital and reserves to self-help measures before it is eligible to request public financial assistance. At June 30, 1986, the System retained approximately $2 billion of available capital and reserves. Thus, the System retains a substantial amount of resources with which to provide self-help if it effectively mobilizes those resources. How quickly, or even if, the System ultimately exhausts its remaining reserves will depend on the future course of economic factors such as land values, commodity prices, the world agricultural situation, and perhaps most importantly, on how well the System manages its financial problems. It is very difficult to predict the future course of the agricultural and world economy with any degree of precision. One certainty exists, however. If the System reduces its loan rates across-the-board by a significant amount, the System's remaining capital will be rapidly dissipated. In this event, and in the absence of public financial assistance, the System could needlessly lose its access to the finanical markets and will be unable to refund its maturing debt or fulfill its lending mission.

Question 3. If federal financial assistance is granted to the FCS, how long do you estimate it would take the System to repay the capital infusion? What do you estimate the difference to be between this capital infusion and the capital infusion that established the System? Why would not the System repay a capital infusion today in the same responsible manner and timeliness that it did some years ago?

Answer 3. It is impossible for me to speculate on how long it would take the system to repay any public financial assistance that it may ultimately be given. Assuming the system eventually requires and receives financial assistance, its ability to repay and the timing of the repayment would depend on the amount of assistance provided, the future condition of the agricultural economy, the magnitude of the System financial problems and its ability to effectively deal with those problems, the amount of self-help the System applies, the level and volatility of interest rates, future land values, and numerous other factors that are not possible to predict at this time.

Obviously there are major differences between today's Farm Credit System and the System which existed in 1916 that make such comparisons interesting but perhaps not very meaningful. The Federal land banks were established with only $9 million of government "seed capital." The initial capital of the Federal intermediate credit banks, banks for cooperatives, and production credit associations, as well as an additional $300 million of government capital in the land banks during the Depression years increased the government's investment in the System to $638 million by 1939. As you may recall, it took the land banks until 1947 (24 years) and the

remainder of the System until 1968 (35 years) to completely repay the government's investment. Today, the System is significantly larger and more complex than at its inception and the financial and agricultural environment is much different than it was in the 1930's and 1940's. Any comparison of government's initial investment in the System to possible future government assistance depends on the same unpredictable factors that I noted above. The System's leadership has indicated that the System would repay any assistance provided to it as rapidly as possible and I am certain they are sincere in this regard.

Question 4. Considering the projected losses in the system, what is a reasonable dollar value of capital that should remain available? If you perfer not to give a specific figure, can you indicate some range of value?

Answer 4. The amount of capital that a System institution should retain to ensure that its financial condition remains safe and sound depends on many factors including a quality of the institution's assets, its type of lending, and the quality of its management. The FCA recently released Capital Adequacy regulations that establish minimum capital levels for System institutions. It would be very desirable for the System to resolve its financial difficulties without drawing any institution's capital level below the minimum requirements established in the Capital Adequacy regulations. However, the Act does require the System to fully commit its financial resources to helping its troubled institutions. The FCA regulations pertaining to the Capital Corporation's funding operations are consistent with this requirement.

Question 5. The System has suggested that a surplus of $1.5 billion is appropriate. Do you think that figure is reasonable or too low?

Answer 5. Because some uncertainty exists on the ultimate magnitude of the System's financial problems, it is difficult to determine what minimum level of capital may ultimately prove to be necessary. If each institution in the Farm Credit System maintained a capital position within regulatory Zone "C" (as defined in the Regulations pertaining to Farm Credit System Capital Corporation assessments) the System would have at least $1.2 billion in available capital and reserves. Capital adequacy, however, is determined individually on an institution by institution basis. Many System institutions have fallen, or been drawn below this level. Many others, mainly production credit associations, have surplus significantly in excess of this amount. Given the diversity of individual situations it is unreasonable to guess what may ultimately prove to be an appropriate aggregate amount.

Question 6. In what banks is the System's surplus located? Have you determined how much of the surplus of these institutions can be used before these institutions are either made non-viable or noncompetitive in the regions they serve?

Answer 6. The following table shows the surplus in each Farm Credit Bank as of June 30, 1986.

FARM CREDIT BANKS SURPLUS (EARNED NET WORTH) JUNE 30, 1986

[Millions of dollars]

	FLB	FICB	BC
Springfield	$59.4	$15.5	$12.2
Baltimore	130.6	21.2	5.0
Columbia	138.3	82.3	15.9
Louisville	0.0	65.4	23.9
Jackson	0.0	21.1	18.2
St. Louis	0.0	39.2	24.8
St. Paul	0.4	21.5	54.3
Omaha	0.0	0.0	13.0
Wichita	0.0	33.6	36.0
Texas	88.9	34.7	15.5
Sacramento	38.0	40.6	21.5
Spokane	81.5	12.8	11.0

I would like to point out that in addition to the surplus held by the banks (which is also referred to as earned net worth), the combined production credit associations hold approximately $1.2 billion of surplus and the combined Federal land bank associations nearly $300 million of surplus. Much of the surplus held by the banks for cooperatives is not subject to assessment by the Capital Corporation because it has been allocated to the cooperatives who own the bank.

The determination of the amount of surplus that may be assessed by the Capital Corporation for purposes of the providing financial assistance to System institutions that are experiencing financial difficulties is determined by the Capital Corporation subject to FCA regulations which require the Corporation to consider the impact of its assessments on the competitiveness and the overall viability of each contributing institution. these determinations are made on an institution-by-institution basis and, therefore, it is not possible to generalize on the effect of such assessments without a careful review of each institution's financial condition.

Question 7. You have indicated that FCA would be patterned after other regulatory agencies, such as the Comptroller's Office, and that safe and sound farm credit institutions would be allowed to set appropriate interest rates.

What would be a good definition of "safe and sound" in this context? What would be "appropriate" interest rates? Is a reasonable standard of market interest rates those rates charged by comparable lenders in the same local?

Do you intend to allow institutions that are now "safe and sound" but have or soon will have their surplus capital drawn down because of loss sharing, set their interest rates as their cost of funds decrease?

Does the Comptroller of the Currency or the FDIC have the authority to set—or to approve—interest rates for the institutions they regulate?

Answer 7. Under the pending FCA regulations establishing adequate levels of capital, institutions operating on a safe and sound basis would be those in zones A and B, and depending on the circumstances, possible institutions in zone C. "Appropriate" interest rates for these institutions will be whatever their management elects to charge, so long as it does not result in the institution dissipating its capital to the extent that it is no longer operating on a safe and sound basis. Rates charged by other lenders in the immediate locale for loans of similar type, quality, and terms would represent the "market rate" for the area. However, as we have discussed today, the rates charged by various lenders may be set on a number of factors, including their operating costs, their market share and competitive strategies.

The proposed capital adequacy regulations include allowances for institutions now operating in a "safe and sound" manner and having their surplus drawn down because of loss sharing to adjust their interest rates as their cost of funds decreases. A portion of contributions to the Captial Corporation are added back in determining an institution's regulatory zone.

The Comptroller of the Currency and the Federal Deposit Insurance Corporation do not have the authority to set interest rates for the institutions that they regulate. However, as regulators, they have the authority to require inadequately capitalized institutions to submit a financial plan to achieve a level of adequate capitalization. Interest rates are a component of these financial plans.

[Written questions submitted by Senator Helms to Mr. Beesley and answers thereto:]

Question 1. What is the average cost of making loans to farmers in both the Land Banks and the Intermediate Credit Banks—including your operating costs and all costs above the cost of debt?

Answer 1. During the first six months of 1986, the System's annualized average operating costs to make and service loans per $100 of average loans outstanding, excluding provisions for losses and interest expense, were as follows:

	FLB/FLBA	FICB/PCA	BC	Weighted system average
.....	$1.04	$3.70	$0.96	$1.72

Question 2. How does your average cost of debt compare to current market rates, or your marginal cost of funds?

Answer 2. As of August 29, 1986, the System's average costs of debt compared with the current marginal cost of various maturities were as follows:

[Amounts in percent]

	FLB/FLBA	FICB/PCA	BC	Total
Average cost of bonds	10.93	8.62	9.36	10.39
Average cost of notes	6.47	6.30	6.29	6.34
Average cost of debt	10.69	8.04	8.03	9.74

Marginal costs of debt (as of September 18, 1986, 10:00 a.m. EDT):

[Amounts in percent]

	FLB/FLBA	FICB/PCA	BC	Total
3 months	5.98	5.98	5.98	5.98
6 months	5.86	5.86	5.86	5.86
1 year	6.24	6.24	6.24	6.24
3 years	7.10	7.10	7.10	7.10
5 years	7.63	7.63	7.63	7.63
7 years	8.29	8.29	8.29	8.29
11 years	8.44	8.44	8.44	8.44

Question 3. Do you have any figures on how your overhead—your margin and other costs of doing business—compares to that of commercial banks involved in agricultural lending?

Answer 3. A recent FCCA study of the 1984 Operating expenses per $100 of average loans for commercial banks with agricultural mortgage loans is summarized as follows:

Deposit size	No. of banks	Operating expense per $100
Up to $50mm	135	$1.16
$50mm to $200mm	268	1.02
Over $200mm	84	1.00

These figures compare favorably with the Land Banks' Operating expense rate/$100 of $1.04 for the first half of 1986, and the BCs' rate of $.96 for the same period. However, the FICB operating rate of $3.70 is extremely high by comparison.

Question 4. If System institutions set rates only by the marginal cost of funds and not your average cost, what effect would that have on the financial condition of the System in the next six months?

Answer 4. The impact of marginal cost, differential (competitive) pricing on the combined Federal Land Banks over the period July 1, 1986 to December 31, 1986 is projected as follows:

As projected under current pricing regulation and policies:

Average accruing loan balance	$35,376,218,000
Interest income	2,045,381,000
Average loan rate (annualized—percent)	11.56

As projected under a competitive pricing policy:

Average accruing loan balance	$38,913,839,800
Interest income:	
10 percent of volume at 9.5 percent	369,681,480
15 percent of volume at 10.0 percent	583,707,600
50 percent of volume at 10.5 percent	2,042,976,600
15 percent of volume at 11.0 percent	642,078,360

10 percent of volume at 11.5 percent	447,509,160
Total	4,085,953,200
Average loan rate (annualized—percent)	10.50

The above analysis assumes that the average volume for the last six months of 1986 would be 10 percent more than would otherwise occur because of the Land Banks' improved competitive posture. This $3.5 billion increase in loan volume would be financed at the current marginal cost of debt of about 6%. It is estimated that this increased volume would be better quality new and retained loans with an average rate of 9.75 percent, thus yielding a 3.75 percent spread or about $65.6 million increase in gross interest margin. The average cost of Land Bank debt during the period would be reduced from 10.67 percent to approximately 10.35 percent, as the Banks would have greater opportunity to add debt to the portfolio at the current marginal cost.

Question 5. If System institutions were allowed to set their own rates, is there any guarantee they would do so in a prudent manner?

Answer 5. At the recently completed National Directors Conference, the District Directors and CEOs agreed by resolution to price in accordance with Systemwide policies and standards in the event of passage of the Cochran and Jones pricing bills, FCCA would develop these policies and standards and would monitor compliance with them such that System profitability and viability were improved from a strategical perspective. These policies and standards would be based on sound and prudent management principles for loan pricing in the current and expected business environment.

Question 6. Will you discuss some of the self-help measures the System has taken to stem losses. Are any further measures planned or being discussed by the System?

Answer 6. The System has shared over $1 billion of its resources in various forms as shown on the enclosed schedule summarizing System self-help efforts. More importantly, System policies have been developed regarding loan forbearance and restructuring and the management and disposition of acquired property. Copies of these policies have been provided to you as part of Mr. Beesley's written testimony. The System is making good progress in implementing these policies, which is expected to result in a reduction in non-accrual loans and acquired properties in the months and years ahead from levels that would occur if sound management action were not taken. In addition, as part of the System's business plan, each district and the central Bank are adopting and supporting cost targets specifically developed to transform the System into a "streamlined, efficient and competitive provider of credit and financial services."

Question 7. Can you comment on the consolidation plan that has been discussed by the FCCA and other System officials?

Answer 7. At their recent national meeting, the District Directors resoluted to continue and intensify the System's study of the structure issue. No specific structure model or approach to restructuring was approved. The System will continue to evaluate its alternatives regarding structure in light of all relevant emerging factors and to share the results of these efforts with the members of Congress.

Question 8. Senator Boschwitz's question on number of branches compared to five largest commercial banks in the world.

Answer 8. During the hearing, Senator Boschwitz requested Mr. Beesley to provide further information regarding Mr. Beesely's statement that the Farm Credit System has more branches and offices than the five largest commercial banks in the world combined. According to a table of information recently published in the *American Banker*, the five largest commercial banks in the world have a total of 1,805 banks branches as compared with the approximately 2,200 branches and other operating locations of the Farm Credit System.

APPENDIX

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

Mr. Chairman, today's hearing concerns a subject of great importance to the farmers, the rural communities, and the banks in my home State of Vermont, and, indeed, in each of our States.

The Farm Credit System holds nearly one-third of the total farm debt outstanding--more than $60 billion of the estimated $210 billion loans. The System suffered a loss of $2.7 billion in 1985. Clearly the System will not be able to sustain losses of that magnitude, and we must carefully monitor the financial condition of the System.

While the Farm Credit System is making progress toward self-help, certain actions of the Farm Credit Administration have impeded actions by the System to extend loans to farm borrowers at a lower interest rate--hurting the System rather than assisting it. The lower cost of funds available to the System should be reflected in lower borrowing costs to farmers. Moreover, without this ability to reduce interest rates, the farm credit banks will be uncompetitive and lose business.

I recently sponsored, along with Senator Cochran and several of our colleagues, a bill--S. 2770--that would prevent undue interference in the farm credit lending system by the Federal regulator. Specifically, the bill allows financially sound farm credit banks to offer lower interest rates.

The measure will directly benefit Vermont farm borrowers. Over 50 percent of the farm debt in Vermont is held by the farm credit banks and it makes no sense to prevent farm credit banks from lowering interest rates if they can.

S. 2770 would strike language from current law that gives the Farm Credit Administration (FCA) the authority to approve interest rates charged by farm credit banks. FCA could not require System institutions to set interest rates charged to eligible borrowers at levels that are higher than interest rates generally available from other commercial lenders under the new bill. I hope that the bill can be considered by the Senate prior to the upcoming recess.

Mr. Chairman, Congress last year adopted changes in the farm credit laws that were intended to benefit the Farm Credit System. I hope that today's testimony will indicate the effect the bill has had. I look forward to reviewing the testimony.

STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM ILLINOIS

Mr. Chairman, I am pleased to be here this morning as the Agriculture Committee again looks into the financial condition of our Farm Credit System.

I am concerned about the health of the Farm Credit System and am especially concerned about the St. Louis district, which serves my home State of Illinois. The Farm Credit System is made up of 37 banks in 12 districts around the country, as well as a variety of other agencies important to farmers. The System holds approximately a third of the Nation's farm debt. Farmers look to the System to provide short-term loans for spring planting and longer-term loans for purchasing equipment and land.

Last week, on the Senate floor, I called upon the administration to appoint the third member of the Board of Directors for the Farm Credit Administration, which is farmer-owned and the largest source of loans for farmers. The administration has had since December 23, 1985, to appoint the entire Board. However, only two of the three members were nominated and confirmed by the Senate. I believe that this delay in making the last appointment may affect the availability and terms of farm loans, as well as the effectiveness of the Farm Credit Administration Board.

We have the responsibility to maintain public confidence in our Farm Credit System. Farmers have enough to worry about already. It is vital that our Farm Credit System be fully staffed, and prepared to handle the present serious farm credit crisis.

STATEMENT OF H. BRENT BEESLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FARM CREDIT CORPORATION OF AMERICA

Mr. Chairman and Members of the Committee.

I appreciate this opportunity to testify today on behalf of the Farm Credit System. I am Chief Executive Officer of the Farm Credit Corporation of America and a member of the Farm Credit Council Legislative Committee.

The Farm Credit Corporation of America was organized in July 1985 by the 37 Farm Credit Banks to establish policy on national issues and to be the System's national spokesman. While we often speak of the Farm Credit System as if it were a single entity, we must remember that this System consists of 488 separate legal entities, each with its own farmer-elected board of directors and fiduciary responsibilities. At times, there are those whose interests are served by seeking to portray our diversity as divisive.

During the last several days, I have been meeting in Albuquerque, New Mexico with the presidents and directors of the 12 Farm Credit Districts and the Central Bank for Cooperatives. While each of us does not agree on every issue confronting the System, we do share a common vision of the vital role of the Farm Credit System in the future of American agriculture and we are united in our appreciation for the strong support and leadership which you, Mr. Chairman, and the members of your Committee provided the System last year. Your foresight and determination led to passage

of the Farm Credit Amendments Act of 1985. This legislation established a blueprint for the future of the Farm Credit System. The task of rebuilding the System has begun, but is not complete.

Mr. Chairman, as I understand it, one of the principal purposes of this hearing is to give you and the members of this Committee an accurate assessment of the current financial condition of the Farm Credit System and our best forecast of future financial conditions.

As you know, the System reported a loss of $968 million for the first six months of 1986, compared to a loss of $2.7 billion in calendar 1985. These losses are a function of three primary factors. First is the large additions to the allowance for loan losses. Additions to the allowance for the first half of 1986 were $982 million. Second is the high level of nonaccrual loans. As of June 30, 1986, these were $7.588 billion, compared to $5.323 billion at December 31, 1985. Third is the high cost of debt. The System's interest expense during the first six months of 1986 was nearly $800 million higher than it would have been had it been paying current market rates on debt.

Procedures for evaluating the System's loan portfolio have improved in the last several months. Our assessment of the System's loan portfolio and the economic factors affecting it--including land values, commodity prices, and net farm income--compels us to continue to build our allowance for loan losses.

As anticipated last year when Congress considered the 1985 Farm Credit Amendments, the System's volume of nonaccrual loans, high risk loans and acquired property has increased dramatically. This reflects the inability of many of our borrowers to service or repay their loans in the current environment. In addition, nonaccrual loans, other high risk loans and acquired property have increased from $10.2 billion at December 31, 1985, to $13.3 billion at June 30, 1986. These nonearning and high risk assets represent a significant drain on System resources.

What do we see for the future?

First, let me say that the Farm Credit System has a Business Plan--which you have been provided--which addresses each aspect of our survival plan. I can represent to you, Mr. Chairman, that the System is addressing each issue that it confronts today. One of the more than 45 business strategies which we have is the development of periodic forecasts of the System's financial condition. We have recently completed the latest round of such forecasts.

Notwithstanding the many uncertainties surrounding these projections and the fact that they were prepared for internal management purposes, it is my desire to share these System-wide results with you today.

o The loss for the full year 1986 is projected to be approximately $1.7 billion. Losses are currently projected to continue during 1987 and 1988, although they are expected to decline significantly from year to year. The projected losses for 1987 and 1988 are $1.1 billion and $600 million, respectively.

o Surplus, which was $3.4 billion at December 31, 1985 and $2.4 billion at June 30, 1986, is projected to decline to $1.7 billion at December 31, 1986, $600 million at December 31, 1987, and a negative $100 million at December 31, 1988.

o Net loan volume is projected to fall from $66.6 billion at December 31, 1985 to $49.5 billion at December 31, 1988.

In evaluating these projections, this Committee must fully appreciate that several uncontrollable factors may significantly impact System earnings during this forecast period. These include changes in general interest rate levels, Federal farm programs, land values, and commodity prices. Some of these factors change daily and are impossible to predict with any degree of certainty. Obviously, the projections for 1987 and 1988 entail greater uncertainties than the projection for 1986. However, even the 1986 projection is subject to considerable uncertainty.

While these projections represent our current best assessment of the future operating results of the System, it would, in our judgment, be inappropriate to use these projections to reach conclusions regarding the necessity for Federal financial assistance or the timing of that assistance. I can report to you today that it is the position of the System's farmer-directors and its management to avoid or minimize the need for Federal financial assistance. We have no plans to ask for such assistance at this time. We continue to meet with officials at Treasury, the Wall Street community and others to explore ways to resolve or reduce our problems in order to avoid the need for Federal financial assistance. We are confident that the process established in the 1985 Amendments will work in the best interests of the System.

The System's self-help efforts are a critical element in this process. In view of pending legal challenges, there is a great deal of uncertainty today about the ability of the Capital Corporation to mobilize System resources to assist troubled institutions. We are greatly troubled by this issue and its potential consequences for the System's future. However, there should be no misunderstanding concerning the System's commitment to the self-help program as mandated by the 1985 Amendments.

o Although the Capital Corporation is only now in the process of making its first assessment, System institutions, pursuant to Capital Preservation and Loss-Sharing Agreements, have already transferred or committed nearly $1 billion of assistance to troubled banks, and substantially all of this has been done after passage of the 1985 Amendments.

o The Farm Credit Corporation of America, on behalf of all the System banks, opposed the efforts of the Amarillo PCA to withdraw from the System.

o The Farm Credit Corporation of America, on behalf of all System banks, intends to support the constitutionality of the 1985 Amendments in the pending or future litigation.

o The Farm Credit Corporation of America has filed extensive comments with the Farm Credit Administration concerning aspects of the assessment regulations that System banks, including both receivers and contributors, believe should be revised to conform to the language and intent of the 1985 Amendments. We were hopeful that these comments would be quickly reflected in revised regulations. In our view, this would have significantly reduced the concerns many System institutions now have with respect to the operations of the Capital Corporation.

It is not surprising to me, nor should it be to this Committee, that System institutions fully expect the Capital Corporation to operate within the carefully crafted parameters set out for it in the 1985 Amendments.

We believe that it is within FCA's ability to produce regulations which can and will be supported by the overwhelming majority

of System institutions, including the System Banks in the two districts that have filed legal challenges to FCA's regulations. We hope that FCA will act promptly to address our concerns.

Furthermore, Mr. Chairman, we are concerned about the Farm Credit Administration's actions to separate the Capital Corporation from the remainder of the Farm Credit System. By issuing arbitrary regulations, without any statutory basis, FCA is prohibiting many of the most able and dedicated System leaders from serving on the Capital Corporation Board, as well as prohibiting the Capital Corporation from drawing on the talented and capable personnel in the Farm Credit System. Through these regulations, FCA has made this important institution much less effective.

During this period of unparalleled financial stress in agriculture and within the System, the System's farmer-directors and management have attempted to retain their focus on business policies to maintain the System's ability to serve the credit needs of agriculture, while providing maximum assistance to our troubled borrowers. In May of this year, the management and farmer-directors of all System banks agreed to actively pursue loan restructuring with borrowers in financial difficulty and adopted a System-wide policy on sales of acquired property. Ad hoc practices which varied district-by-district were replaced by a single process for the System to follow in working with financially-stressed customers.

Our policy states that we will use forbearance and debt restructuring as preferred alternatives to foreclosure. We fully recognize that not every borrower can survive the current depression in agriculture. However we will respond fairly to our customers who are candid and who will work with us in assessing the viability of their operations under forbearance and restructuring plans. This policy will minimize System losses and lessen the number of foreclosures, which are both costly and painful to all involved.

We have also responded to what is clearly the most widespread concern of our borrowers--namely high and noncompetitive interest rates--with a Farm Credit System Model Pricing Program. It was developed to help both borrowers and the System. Borrowers need interest rate relief; the System needs to maintain its customer base in order to preserve the earnings base necessary to work through its problems.

It has become evident that continued regulatory control over System interest rates will prevent us from fully implementing our new pricing program. At the Albuquerque meeting there was wholehearted support for S. 2770, The Farm Credit System Borrower Interest Rate Relief Act of 1986, recently introduced by Senator Cochran. No financial institution can mount a recovery by charging noncompetitive interest rates. Certainly, those of you who labored so hard to obtain swift enactment of the 1985 Amendments did not do so with the understanding that the System would lose its ability to provide credit to eligible borrowers on "reasonable and competitive terms."

Notwithstanding comments to the contrary by Chairman Naylor and others, the System has the self-discipline necessary to administer a responsible differential rate lending program as contained in the Farm Credit System Model Pricing Program. The issue is whether farmer-directors and their management or the regulator determine what rates are competitive. I cannot predict what these

rates will be, but it is my belief that in several districts System rates are not competitive. For example, one large agricultural lender in the Western United States, which has, like the System, recently suffered significant financial losses, is currently undercutting the Farm Credit System by 2-3 percent.

Using the base projections previously discussed, we have attempted to project the impact of various interest rate reductions on the financial forecasts for the FICBs/PCAs and the FLBs/FLBAs. In developing the alternative scenarios, we have assumed that as rates are lowered, loan volume will increase over the base forecast and the level of problem assets and chargeoffs will decrease. Although it is impossible to prove the validity of these assumptions, we believe that they are reasonable business predictions, based on our perception of the current agricultural lending environment.

In each of the alternatives presented, the benefits to borrowers far outweigh the related costs to the System. If we extended the projection further, the benefit to the System in terms of a long-term earnings potential would be evident. Long-term earnings are crucial to the System's ability to replenish its depleted surplus.

We reject the argument that FCA control over interest rates is necessary to prevent continued escalation of losses in poorly managed System institutions. Nothing in Senator Cochran's legislation prevents FCA from exercising its enforcement powers to correct bad management practices. This legislation does not commit Congress to an open-ended multi-billion dollar assistance package. It will, if passed, enable the System to continue to fulfill its Congressional mandate to be a dependable source of competitively-priced credit to farmers, ranchers and cooperatives.

Mr. Chairman, we believe that the Farm Credit System has a key role to play in supporting and strengthening U.S. agriculture. I can assure Members of this Committee that the Farm Credit System will do everything within its power to recover from its current economic problems and return to long-term profitability. We will continue to meet the financial service needs of farmers, ranchers and cooperatives. We will maintain an open and candid dialogue with the Congress and the Administration as we proceed.

FARM CREDIT SYSTEM STRATEGIC AND BUSINESS PLAN

I. INTRODUCTION

The Farm Credit System and American agriculture which it serves are confronted with challenges not seen since the Great Depression. These challenges require well-planned, coordinated and decisive action.

The Farm Credit System Mission Statement and Strategic Objectives provide systemwide long-term direction. The purpose of the Business Plan is to identify and focus the system toward objectives that need to be accomplished during 1986 and 1987 in order for the system to achieve its Mission Statement and the long-term Strategic Objectives.

Each bank, association, and system service entity (including the Capital Corporation), is responsible for developing its own

business plan consistent with local priorities and the provisions of this Farm Credit System Strategic and Business Plan.

II. FARM CREDIT SYSTEM MISSION STATEMENT

The Farm Credit System will be the nation's premier provider of credit and financial services to farmers, ranchers, cooperatives and other eligible entities.

III. ENVIRONMENTAL ANALYSIS AND ASSUMPTIONS

A. Environmental—Overview

Throughout the 1980s agriculture has experienced economic turmoil. While the nation as a whole has participated in a period of recovery and prosperity, unprecedented in length, agriculture has been excluded. Barring unforeseen developments, all indications lead to the conclusion that agriculture's recovery will remain stalled.

This overview highlights key findings of an environmental analysis prepared by the Farm Credit System (FCS). The environmental analysis covers, in separate reports, the general and agricultural economy and financial, ag credit, cooperative credit, competitive, human resources and political environments. The analysis supports the system business plan and is the basis for developing an action plan to help the system deal with these forces.

The General and Agricultural Economy

In 1985, the general U.S. economy grew at a rate of 2.3 percent, when adjusted for inflation. The recovery passed the three-year mark late last year, yet there is little concern for a near-term recession. The U.S. economy will continue to expand for the next few years, although growth is expected to be weak.

Even though the general economy emerged from the recession in 1982, agriculture did not. One out of every 20 farmers went out of business last year, and one out of 25 filed bankruptcy.

Land values nationwide have declined almost 30 percent since 1981, with parts of the Midwest and Great Plains posting declines of 50 to 60 percent. Farmland values fell 13 percent from April 1984 to April 1985. Preliminary data shows another 12 percent drop from April 1985 to February 1986. In 1985, Texas land values registered a 17 percent decline--the first in several years. Farmland values will stabilize in many parts of the country during the next three years, but are not expected to rise.

In 1985, nominal net farm income fell nearly $8 billion below 1984 levels. Net farm income is expected to be approximately $23 billion in 1986 and about $30 billion in 1987. Most of this increase will result from government programs rather than market prices. In fact, farm prices during the first two months of 1986 averaged about 10 percent less than 1985, and significant price recovery is not expected during the next few years.

World production is one of the major forces behind the U.S. agricultural economy. Worldwide supplies continue to exceed demand when measured in terms of ability to pay. Produce from one of every three acres of production in the U.S. goes to export markets. Past U.S. policies have helped stimulate worldwide production, contributing to a decline in U.S. export markets.

This, in conjunction with several excellent growing years in a row, has helped build commodity surpluses and reduce prices.

The drop in U.S. agricultural exports is projected to bottom out at $28 billion during the current fiscal year. Changes in U.S. support programs will allow American agriculture to increase exports as world demand increases. But volumes achieved in the early 1980s will not repeat themselves.

As the farm recession continues, the use of agricultural credit will decline. In the last three years, total farm debt has declined by $5 billion, to $211 billion as of December 31, 1985. The size of the agricultural credit market will likely fall to $165 to $185 billion by 1990. From January 1, 1985 to January 1, 1986, the Farm Credit System market share has declined from 31 percent to 28.7 percent. Commercial banks' share has declined from 24.2 to 22.3 percent, and insurance companies' from 5.9 to 5.6 percent. Increases in Farmers Home Administration (FmHA) and Commodity Credit Corporation (CCC) volume account for most of these market share losses. If the system maintains its current market share through 1990, total system volume, could be in the mid to upper $50 billion level. The Banks for Cooperatives share of that total could be about $10 billion.

A number or recent developments are expected to have a major impact on agriculture and the entire Farm Credit System.

1. The federal deficits and the Gramm-Rudman amendment could have major impacts. If Gramm-Rudman takes effect in 1986, subsidy payments to farmers will be reduced by 4.3 percent. In 1987, payments would be reduced by 8.4 percent, with larger cuts likely in 1988 and 1989. However, a reduced deficit could have a positive impact on agriculture in the long term.
2. The Farm Security Act of 1985 provides significant security to farm income which makes it a prime target for Gramm-Rudman. The 1985 farm bill is the most expensive farm bill ever. It will lower loan rates, provide government deficiency payments, conserve 4 million acres, buy out whole dairy herds, and provide more FmHA guaranteed loans.
3. The decline in the exchange rate of the U.S. dollar should have a positive effect on exports and production costs during the next few years, although minor.
4. The rapid expansion of the money supply has dropped the prime rate to 8.5 percent, decreased long-term Treasury rates by nearly 200 basis points over the last two years to 9.5 percent, and dropped short-term rates by 70 basis points over the last two years to 7.7 percent. As these interest rates filter down to the farm sector, farmers' interest rate reductions will be modest compared to drops in the money markets.

Farm Credit System cost of funds is expected to range from 35 to 50 basis points over Treasury bills during the next three years. Although agency status will be retained in some form, the difference between the system's cost of funds and competitors' costs will narrow.

Banks for Cooperatives

The financial stress in agriculture continues to force cooperatives to emphasize risk management, operating efficiency and competitiveness. Many are downsizing operations or specializing

within a narrow scope. Many are adopting more sophisticated financial tactics. In the process, they are becoming a different type of borrower than traditional Bank for Cooperatives customers. Fewer, larger cooperatives which overlap existing Farm Credit districts are expected. These trends will change financial institutions that serve cooperatives.

Competitive Environment

Direct competition will continue from all financial institutions, but small- to mid-size commercial banks will be the major competitors for production loans over the next few years. The 50 commercial banks with the largest agricultural portfolios account for only $9 billion in agricultural credit. Small- to mid-size banks account for about 70 percent of the nation's commercial bank agricultural credit.

Commercial banks remain ready to serve financially sound producers and to take advantage of a rebound in agriculture. Various lenders are attempting to develop a secondary market for mortgage loans. Many banks have the flexibility to negotiate fees and have an array of products that agricultural customers will find attractive.

Data provided by the Federal Reserve Banks in 1984 allow for a comparison of Farm Credit System operating expenses versus that of 400 commercial banks. Operating expenses for the lending function for those banks, as a percent of loan volume were about 26 to 63 basis points lower than those of the Federal Intermediate Credit Bank-Production Credit Associations (PCAs). Commercial bank operating expenses were 118 to 155 basis points higher than the 12 Banks for Cooperatives, and were 41 to 57 basis points higher than the Federal Land Banks.

Competitive price remains a key demand of agricultural credit customers. Based on a systemwide poll, many Farm Credit districts are not competitively priced. Commercial banks have a price advantage that allows them to capture a significant share of quality agricultural loans.

Human Resources

Key employee turnover within the system is high. The system is losing many highly qualified loan officers and managers, and is having difficulty replacing them with comparable employees. This is happening despite growing concern among the nation's work force about career security in professions for which they have been trained.

Political Environment

Congress is aware of the problem faced by FCS, but any request for congressional funds will be difficult in light of the budget-reduction mood. They expect the system to follow the aid-request process they adopted in December, and will watch for system efforts to deplete surplus for the purpose of hastening government assistance.

Conclusion

The environment will provide little relief for the Farm Credit System and continues to present many challenges. It will take the efforts of all system employees, pulling together to develop effective strategies to meet the challenge.

B. Assumptions

1. The farm economy is not expected to improve during the next two to three years. Land values, net farm income and commodity prices are not expected to rise above current levels.
2. Farm Credit System loan volume is projected in the mid to upper 50 billion dollar range by 1990, down 20-25% from the levels reached in the mid 80's.
3. The system's average net cost of funds at the margin will be approximately 50 basis points over U.S. Treasury obligations of comparable terms (including the cost of the Funding Corporation). Long-term funds may have a greater spread over treasuries.
4. The system can be competitive in the farmer-rancher segment of the market with an average spread of 300 basis points over U.S. Treasury obligations of comparable terms. (Differential pricing is assumed.)
5. High performance competitors will have a total operating cost of approximately 6 basis points.
6. High performance competitors will obtain funds at approximately the same price as the Farm Credit System.
7. The general level of interest rates and the shape of the yield curve cannot be accurately predicted on a consistent basis.
8. The future consumer of agricultural credit will have a greater variety of innovative credit and financial products available than ever before.
9. System employees will face continued stress and job dissatisfaction resulting in an unsatisfactorily high turnover rate and difficulty in attracting comparable replacements.
10. Major parts of the system will not survive unless the system utilizes available capital resources.
11. Cooperative mergers and restructuring will have a major impact on the financial requirements of cooperatives and services requested by them.
12. For the next three to five years, the major competition for production loans will remain small to medium size rural banks. In California and the southeast, there is competition from large commercial banks.
13. The BCs will continue to face competition from regional/national banks and increasingly from U.S. branches of foreign banks.
14. Efforts will be made by various lenders to develop a secondary market for long-term loans.
15. The system's investors and stockholders will demand accurate and timely financial information on an institutional, district and systemwide basis.

VI. FARM CREDIT SYSTEM STRATEGIC OBJECTIVES

The Farm Credit System will:

A. Be a dependable source of high quality, financial and credit-related services to all qualified customers.
B. Price products on the basis of competition, risk incurred and cost of delivery.
C. Maximize efficiency and effectiveness in the delivery of products and services and in the management of human and physical resources.
D. Maximize long-term profitability to support growth, strengthen the system's capital base, and provide a competitive return on owner's investment.
E. Assess, manage and control credit, interest-rate and liquidity risk.

V. FARM CREDIT SYSTEM BUSINESS PLAN

A. Business Plan Objectives

To return the Farm Credit System to profitability and accomplish the system's Strategic Objectives, the Farm Credit System must accomplish the following Business Plan Objectives during 1986 and 1987:

1. Effectively work with troubled accounts, reduce non-earning assets and manage acquired property;
2. Attract and retain quality customers and employees during this period of transition;
3. Transform the system into a streamlined, efficient and competitive provider of credit and financial services;
4. Implement programs to assess, manage and control interest-rate, credit, liquidity and other risks; and
5. Build system financial strength and maintain independence through compliance with system standards, equitable utilization of capital, and improved financial monitoring, reporting and forecasting.

B. Business Plan Strategies

Included for each major Business Plan Objective are "Bank and Association Strategies" which require bank and/or association action or planning. Also included is a section labeled "Systemwide Strategies." These strategies require action and/or planning by one or more of the system committees and/or service organizations. Where a system committee or service organization is designated, it is presumed that entity will work through established procedures to obtain system input and approvals. For example, FCCA will work through standing committees to obtain presidential agreement on new standards, policies or guidelines.

Business Plan Objective 1. Effectively work with troubled accounts, reduce non-earning assets and manage acquired property

Bank and Association Strategies

a. By June 3, 1986, each bank and association shall adopt and implement the Farm Credit System Guidelines and Definitions for Restructuring Troubled Loans and shall monitor and report results. (Appendix A)

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b. By August 31, 1986, each bank and association shall adopt and implement the Farm Credit System Guidelines and Definitions for Management and Disposition of Acquired Property and shall monitor and report results. (Appendix B)
c. As soon as practicable, each bank and association shall review each non-earning asset (other than loans or acquired property) and perform a cost/benefit analysis of retaining those assets.

Systemwide Strategies
a. FCCA shall compile system data and monitor compliance with loan restructuring and acquired property guidelines and take initiative for appropriate corrective action.
b. By June 30, 1986, the Capital Corporation shall develop and obtain system input and agreement on the Capital Corporation's mission in accomplishing appropriate actions regarding troubled accounts and acquired property.
c. FCCA and The Farm Credit Council (FCC) shall communicate system loan restructuring and acquired property results to appropriate publics.

Business Plan Objective 2. Attract and retain quality customers and employees during this period of transition

Bank and Association Strategies
a. By May 31, 1986, each bank and association shall adopt and commence implementation of the Farm Credit System Model Pricing Program. (Appendix C)
b. By July 31, 1986, each bank and association shall review and evaluate existing marketing and communications programs and develop and implement improved programs, as required, which contain at least the following elements:
   (1) Programs to identify and personally contact potential high quality customers.
   (2) Programs to communicate and market to existing and potential borrowers the Model Pricing Program and other relevant components of the Farm Credit System Strategic and Business Plan.
   (3) Programs regarding district marketing efforts, advertising, community relations and communications that link all components together.
   (4) Programs to "mend fences" with borrowers and bring back customers who have left the system.
c. By December 31, 1986, each bank and association shall review and evaluate existing human resource programs and develop and implement improved human resource programs, as required, to identify, attract, train and retain key employees.
d. Each bank shall develop and implement programs and services to serve a broader range of customer needs and to increase non-interest revenue.

Systemwide Strategies
a. By June 30, 1986, FCCA shall refine the systemwide communications program to reinforce current Business Plan objectives.
b. The Farm Credit System, through the Farm Credit Council and in coordination with FCCA, shall assure a continuing con-

structive and proactive relationship with appropriate legislative and governmental bodies.

c. By September 30, 1986, FCCA shall develop and present to the system the following human resource initiatives:
   (1) Standards for human resource information systems.
   (2) Model "pay-for-performance" and incentive compensation programs.
   (3) Model manpower planning programs focused on association personnel.
   (4) Model systemwide benefits programs.

d. FCCA, in coordination with the FCC, the Funding Corporation and system banks, will institute an ongoing schedule of meetings with leaders of national, financial, media and legislative organizations.

Business Plan Objective 3. Transform the system into a streamlined, efficient and competitive provider of credit and financial services

Bank and Association Strategies

a. By October 31, 1986, each district and the CBC shall adopt and support an operating cost target* for 1987, 1988 and 1989 based on projected business volume, which will achieve a competitive system total operating cost relative to total system volume. (See method of establishing Operating Cost Target in Appendix D)

b. By November 30, 1986, each bank shall develop a migration plan to implement business technology standards. (Appendix E)

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*Note: Variable costs incurred in the management of troubled accounts and acquired property and other costs which are directly offset by non-interest income may be excluded from the above target.

Systemwide Strategies

a. The Farm Credit System shall develop a plan to present to the presidents in July 1986 which will combine all system units in order to improve profitability and competitiveness, increase economies of scale, pool capital and serve the unique needs of each market segment while retaining district/local operational authorities to the extent practical and in keeping with sound business principles.

b. By October 31, 1986, each system service organization (including the Capital Corporation) and committee shall conform and justify its operating costs to the overall benefit it provides the system and shall demonstrate its plans to eliminate duplication with other system entities.

c. By January 1, 1987, FCCA shall develop and implement a systemwide reporting structure to serve the reporting and monitoring needs of the banks, associations, FCA, FCCA, the Capital Corporation, system committees and other system entities.

d. FCCA shall develop and maintain a constructive relationship with FCA to move the regulator away from management and to reduce regulatory delays and cost burdens to the system.

e. FCCA shall monitor compliance with business technology standards and take initiative for appropriate corrective actions.
f. During 1986, FCCA shall explore additional opportunities to reduce operating costs through system joint purchasing, etc.

Business Plan Objective 4. Implement programs to assess, manage and control interest-rate, credit, liquidity and other risks

Bank and Association Strategies

a. By May 31, 1986, each bank and association shall adopt and commence implementation of the Farm Credit System National Credit Standards. (Appendix F)
*b. By September 30, 1986, each bank shall adopt and commence implementation of the Farm Credit System Asset/Liability Management Guidelines. (Appendix G)
*c. By August 31, 1986, each bank shall adopt and commence implementation of Farm Credit System Liquidity Guidelines.

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* Approval of these two guidelines await their development.

Systemwide Strategies

a. FCCA and/or the Funding Corporation shall compile system data and monitor compliance with the above system standards and guidelines and take initiative for appropriate corrective action.
b. FCCA shall monitor and coordinate litigation on systemwide issues.
c. By August 31, 1986, FCCA shall develop a program to accept the delegation of the system's insurance and risk management responsibilities.
d. FCCA shall engage and manage the systemwide auditing firm and the various legal counsel and consultants retained for systemwide issues.

Business Plan Objective 5. Build system financial strength and maintain independence through compliance with financial standards, equitable utilization of capital, and improved financial monitoring, reporting and forecasting

Bank and Association Strategies

a. By July 31, 1986, each bank shall adopt the National Financial Standards and Guidelines. (Appendix 1)
b. [*A systemwide financial plan is anticipated.]
c. Each bank shall integrate updated financial projections into business plans on an ongoing basis.

Systemwide Strategies

a. [By July 31, 1986, the Farm Credit System shall adopt a system financial plan which addresses capital utilization and the system's relationship with the Capital Corporation.]
b. Systemwide financial information shall be prepared and reported by the Funding Corporation and/or FCCA as appropriate.
c. By October 31, 1986, FCCA and FCC shall develop a contingency plan for obtaining federal assistance.

d. By August 31, 1986, the Capital Corporation shall develop and obtain system input and agreement on the Capital Corporation's mission in accomplishing system self-help.
e. Each bank and service entity shall develop its own Business Plan consistent with local priorities and the Farm Credit System Strategic and Business Plan and participate in an annual plan review facilitated by FCCA in November 1986 and 1987. FCCA will monitor progress on the Business Plan and make periodic progress reports to the system.

VI. APPENDIX

A. Farm Credit System Guidelines and Definitions for Restructuring Troubled Loans
B. Farm Credit System Guidelines and Definitions for Management and Disposition of Acquired Property
C. Farm Credit System Model Pricing Program
D. Farm Credit System Operating Cost Target Calculations
E. Business Technology Standards
F. Farm Credit System National Credit Standards
G. Farm Credit System Asset/Liability Management Guidelines
H. Farm Credit System Liquidity Guidelines
I. Farm Credit System National Financial Standards and Guidelines

Appendix A

The final approved version of the draft Farm Credit System Guidelines and Definitions for Restructuring Troubled Loans, approved by the presidents May 5-6, 1986, and the FCCA Board, May 8, 1986, is made a part of this Business Plan by reference.

Appendix B

The final approved version of the Farm Credit System Guidelines and Definitions for Management and Disposition of Acquired Property, approved by the presidents May 5-6, 1986, and the FCCA Board, May 8, 1986, is made a part of this Business Plan by reference.

Appendix C

The final approved version of the Farm Credit System Model Pricing Program, approved by the presidents May 5-6, 1986, and the FCCA Board, May 8, 1986 is made a part of this Business Plan by reference.

Appendix D

FARM CREDIT SYSTEM OPERATING COST TARGET CALCULATIONS

		TOTAL OPERATING COST TARGETS FOR SELECTED FARM CREDIT SYSTEM LOAN VOLUMES			
		$55B	$60B	$65B	$70B
		(Millions)			
Maximum Basis Points of Operating Cost to be competitive	80	$440	$480	$520	$560
	70	385	420	455	490
	60	330	360	390	420
	50	275	300	325	350

Using the Assumptions cited in the Business Plan, the above table can be used to establish a Farm Credit System total operating cost target of $390 million as follows:

If system loan volume equals $65 billion and the maximum operating cost to be competitive is 60 basis points, then the Farm Credit System total operating cost target would be $390 million.

A similar calculation should be made to establish each district's total operating cost for 1987, 1988 and 1989.

(Note: Variable costs incurred in the management of troubled accounts and acquired property and other costs which are directly offset by non-interest income may be excluded from the above target.)

Appendix E

BUSINESS TECHNOLOGY STANDARDS

		Approval		
Subject Standard	C&O	37/PRES	FCCA Board	District Board
Mainframe Hardware-IBM	11/15/85	1/16/86	2/4/86	3/86
Operating System-MVS/XA	11/15/85	1/16/86	2/4/86	3/86
Data Base Mgt-ADABAS	11/15/86	1/16/86	2/4/86	3/86
4 Gen. Language-Natural	11/15/86	1/16/86	2/4/86	3/86
Communications Monitor-IBM/CICS	11/15/86	1/16/86	2/4/86	3/86
Utility Software-Computer Associates (15 different systems)	4/30/86	To Be Presented 5/5/86		
General Accounting-M&D (General Ledger + 5 other systems)	1/8/86	2/6/86	2/13/86	3/86

The final approved version of all Business Technology Standards referenced above and future approved Business Technology Standards

are made a part of this Business Plan by reference. Complete copies available from Farm Credit Corporation of America.

Appendix F

The final approved version of the Farm Credit System National Credit and Review Standards as approved by the presidents, January 16-17, 1986, the FCCA Board, March 5-6, 1986, and the district boards in March and April, 1986 is made a part of this Business Plan by reference.

Appendix G

When approved, the Farm Credit System Asset/Liability Management Guidelines will be made a part of this Business Plan by reference.

Appendix H

When approved, the Farm Credit System Liquidity Guidelines will be made a part of this Business Plan by reference.

Appendix I

When approved, the Farm Credit System National Financial Standards and Guidelines will be made a part of this Business Plan by reference.

THE FARM CREDIT SYSTEM—CURRENT AND PROJECTED FINANCIAL RESULTS AND CONDITION

FORECAST RISKS

There are several factors which create significant risk that these projections may prove to be inaccurate with the passage of time.

The key assumptions of these projections are as follows:

The System will be able to sell bonds, notes and other forms of debt at rates of about 5 basis points over comparable new Treasury issues.

The cost of new debt will decrease slightly during the remainder of 1986 and will then increase very moderately for the remainder of the projection period.

The macro assumption for land values was a continued decline in 1986 and early 1987 at a moderate rate. Values would tend to stabilize in late 1987 and a modest increase would occur in 1988. Each District developed individual assumptions regarding trends in land values and net farm income within these guidelines.

No future changes in government agricultural policies and programs were anticipated. Any change may have a significant impact on these forecasts.

Each District developed individual assumptions regarding loan interest spreads, nonearning asset trends, adequate allowance for losses, and inflation rates.

Banks were directed to assume no additional financial assistance on an interdistrict basis beyond June 30, 1986. Programs which were currently in place for banks providing assistance to associations were to continue. The projections do not include assessments from the Capital Corporation. Each Bank and Association project future financial conditions and results of operations without the provision or receipt of System financial

assistance either via the Capital Preservation and Loss Sharing Agreements or through the Capital Corporation.

BACKGROUND AND METHODOLOGY

This update of System Financial Projections is the result of a cooperative effort by District banks and FCCA staff. It is intended for internal use within the Farm Credit System by Directors, CEOs and senior managers as a strategical and operational planning tool. Similar financial projection updates will be prepared on a semiannual basis in the future.

These projections include the accounts of the Federal Land Bank Associations and the Production Credit Associations combined with the related District banks. The projections include the service entities of the Farm Credit System under the equity accounting method. The service entities are the Farm Credit Corporation of America, the Farm Credit Funding Corporation, the Farm Credit Leasing Services Corporation and the Farm Credit Capital Corporation.

Each District produced financial projections for the Land Bank, Intermediate Credit Bank and the Bank for Cooperatives using various computer models developed by System and FCCA staff. The Districts also produced financial projections for the related FLBAs and PCAs on a combined District basis. These bank and association projections were then released to FCCA. FCCA staff then processed these submissions through a series of programs which combine the related entities. The process includes quality and production controls to assure accuracy and reasonableness at each step.

The Districts were provided a standard yield curve forecast for projected sales of debt.

The Districts were asked to assume there would be no additional Capital Preservation Agreement activations or other interbank financial assistance beyond that which was actually in process as of June 30, 1986. They were also asked not to anticipate any other purchases of loans or other assets by the rechartered Capital Corporation. This was done to better define the System's emerging need to engage in self-help.

Districts were encouraged to coordinate their projections for banks and associations so that each of them reflected a common set of assumptions and results regarding interactive and interdependent factors, such as loan volume, loan rates, certificates of indebtedness, association compensation, earnings and capital, dividends and patronage refunds, and financial assistance provided to associations by banks.

Finally, the districts were encouraged to be neither optimistic nor pessimistic as they developed the key assumptions for their projections. They were asked to be objective and realistic in assessing the current trends in agricultural economics and in determining how the trends would likely effect their projected financial conditions and results of operations prepared in accordance with generally accepted accounting principles. The key forecasting assumptions in this regard are: the trend in accruing loan volume in light of the expected competitive environment, the trend in nonaccruing loans and acquired property, the trend in chargeoffs on nonaccruing loans and acquired property, the adequacy of the allowance for losses at future points in time, the

expected ability to collect delinquent loans and to dispose of acquired property, and the impact on an FICB and nonstressed PCAs of the provision of financial assistance to stressed PCAs.

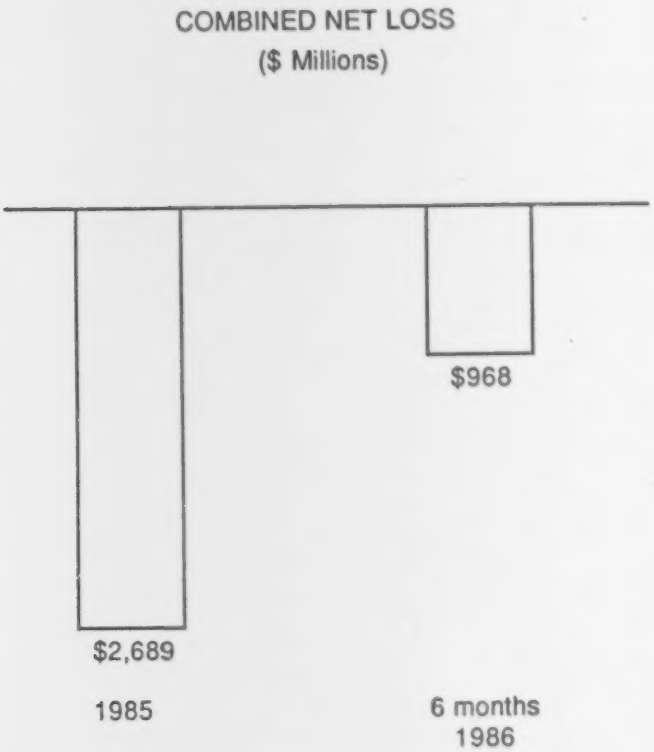
OBJECTIVES:

- Review actual combined financial results and conditions through June 30, 1986
- Discuss projected financial results for the balance of 1986 and 1987-88

- The actual combined results of operations and financial condition illustrated in the following slides are taken from the System's "Reports to Investors".

- The bottom line for 1985 and the first 6 months of 1986 is, of course, unprecedented losses - nearly $2.7 billion in 1986, nearly $1 billion so far in 1986.

RESULTS OF OPERATIONS



- Net interest income, the difference between interest earned from loans and investments, and interest paid on System debt outstanding, only slightly exceeded net operating expenses in 1985 and 1986.

- Accordingly, for the most part the provision for losses translates into net loss.

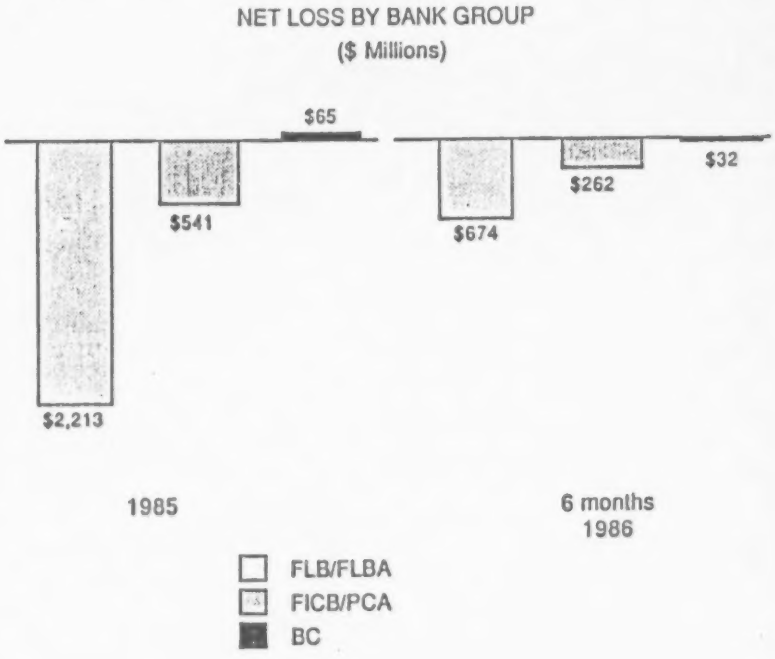
RESULTS OF OPERATIONS

COMPONENTS OF NET LOSS
($ Millions)

	Actual	
	1985	6 Mos. 1986
Net Interest Income	$1,295	$456
Provision for Loan Losses	2,969	982
Net Operating Expenses	1,015	442
Net Loss	$2,689	$968

- The largest net operating losses have been incurred by the Federal Land Banks where the greatest amount of actual and potential loan losses are occurring.

RESULTS OF OPERATIONS



Other factors besides loan losses are impacting the size of the net loss.

- The net interest margin has declined from 1.72% in 1985 to 1.27% for the first six months of 1986. Several land banks are operating at a negative net interest margin due to high volume of nonaccrual loans.

- It is very difficult to reduce operating expense commensurate with loan volume principally because of the high cost of servicing delinquent loans and acquired property.

- Lost loan volume is costing the System several hundred million dollars in net interest income.

RESULTS OF OPERATIONS

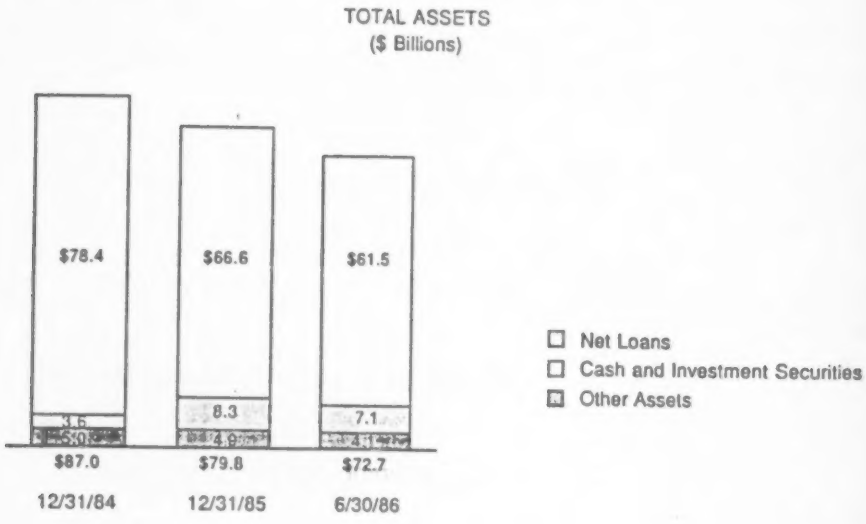
KEY FACTORS IMPACTING LOSS

- Large provisions for loan losses
- Declining net interest margin %
- Operating expenses remain high
- Declining loan volume

- Combined net assets have declined from $87 billion at the end of 1984 to less than $73 billion at June 30, 1986 - a more than 16% drop.

- Liquidity, cash and investments, now represent nearly 10% of total assets versus 4% at the end of 1984 giving a small comfort to the funding markets.

FINANCIAL CONDITION

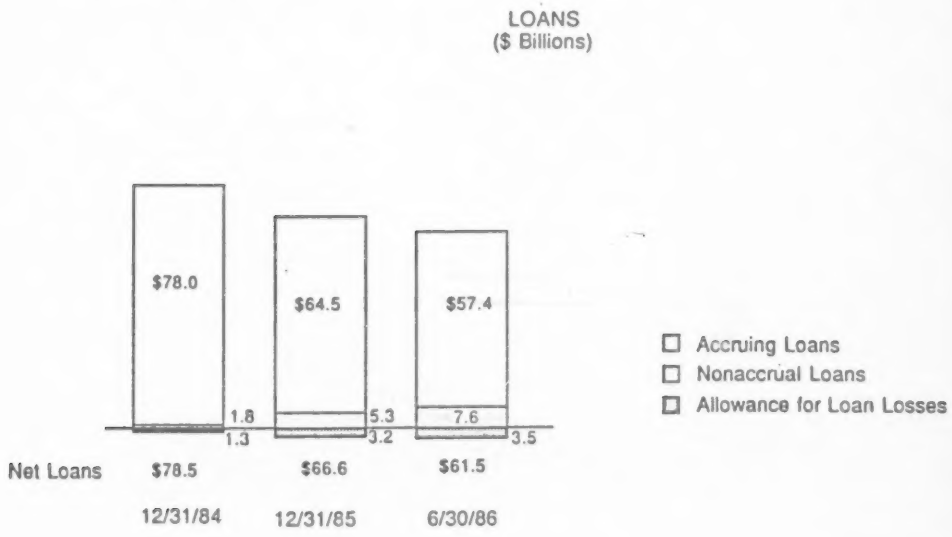


- Net loans have declined almost 22% from $78+ billion at December 31, 1984 to $61.5 billion at June 30, 1986.

- More disturbing is that accruing loans have declined 26.4% with nonaccrual loans rising to $7.6 billion at June 30, 1986

- The allowance for loan losses has increased commensurate with, but not proportionate to, the level of nonaccrual loans.

FINANCIAL CONDITION

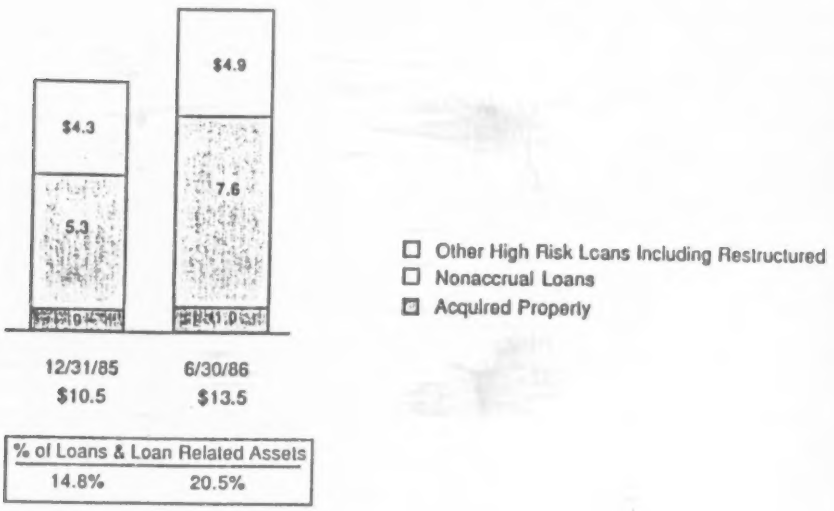


o This slide illustrates the root cause of the System's current financial problem.

- High risk assets have risen to $13.5 billion at June 30, 1986 or 20.5% of loans and loan related assets. High risk assets include $1 billion of acquired property; $7.6 billion of nonaccrual loans; and $4.9 billion of other high risk loans of which 1.2 billion are seriously delinquent and most of the rest are undercollateralized.

FINANCIAL CONDITION

HIGH RISK ASSETS
($ Billions)



% of Loans & Loan Related Assets	
14.8%	20.5%

- The combined allowance for loan losses now stands at 5.3% of gross loans and 27.6% of high risk loans. Keep in mind that the allowance for losses is set aside for potential losses in the entire portfolio not just high risk loans.

- The combined FLB/FLBA allowance equal approximately 25% of the estimated undercollateralized loans and in total more than equals the exposure on undercollaterized loans.

FINANCIAL CONDITION

ALLOWANCE FOR LOAN LOSSES

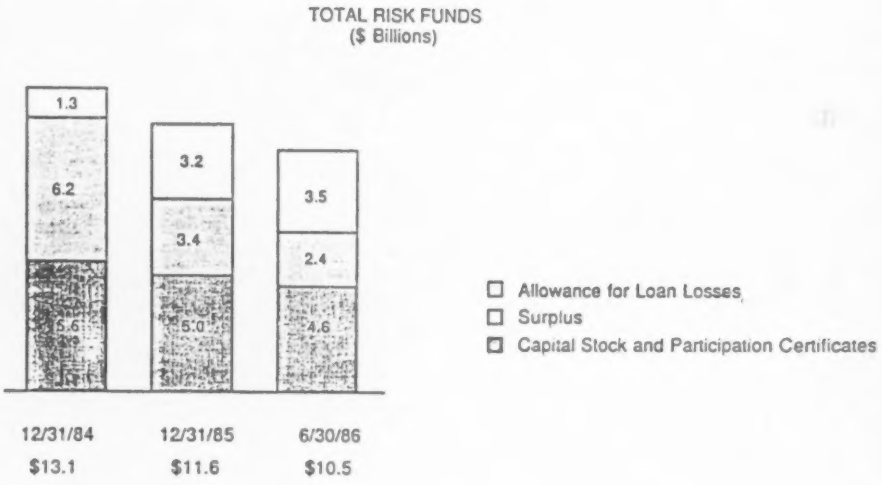
	12/31/85	6/30/86
Combined FCS		
% Gross Loans	4.6%	5.3%
% High Risk Loans	33.4%	27.6%
FLB/FLBAs		
% Est. Undercollateralized Loans	–	25%
% Est. Exposure on Undercollateralized Loans	–	120%

- Total risk funds including the allowance for loans losses continues to slide.

- More importantly the cushion to member stockholders, that is surplus, has declined from $6.2 billion at December 31, 1984 to $2.4 billion at June 30, 1986.

  - The next two slides focus on this key item - surplus.

FINANCIAL CONDITION

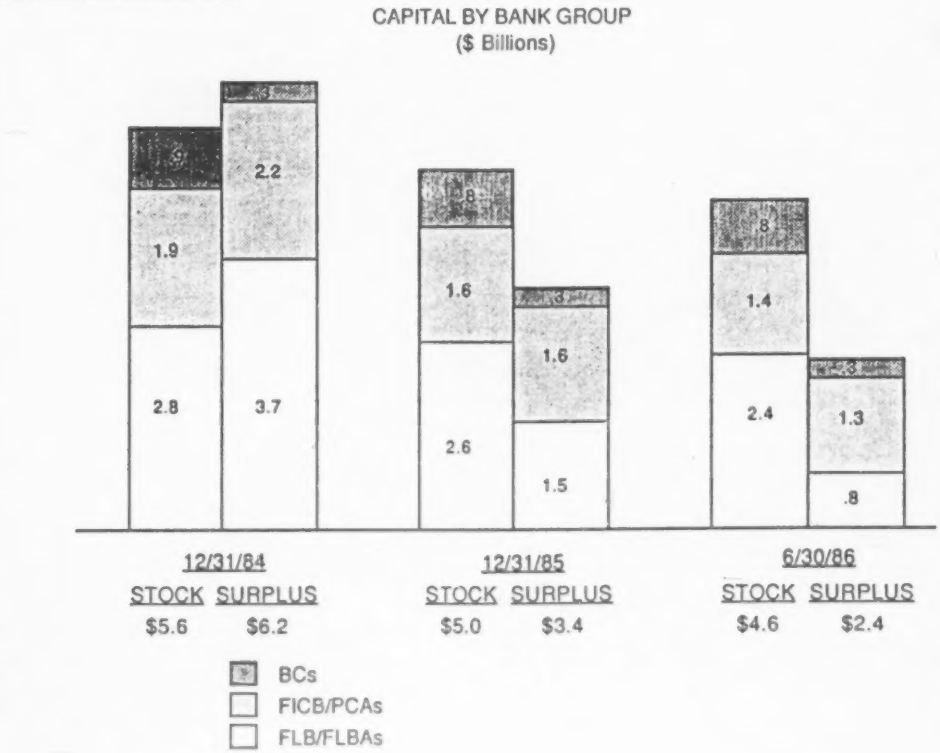


- Surplus exceeded stock at December 31, 1984. In other words for every dollar of member stock, there was approximately $1.10 of surplus.

- At June 30, 1986 that Cushion of "surplus" has diminished to approximately 50 cents for every dollar of stock.

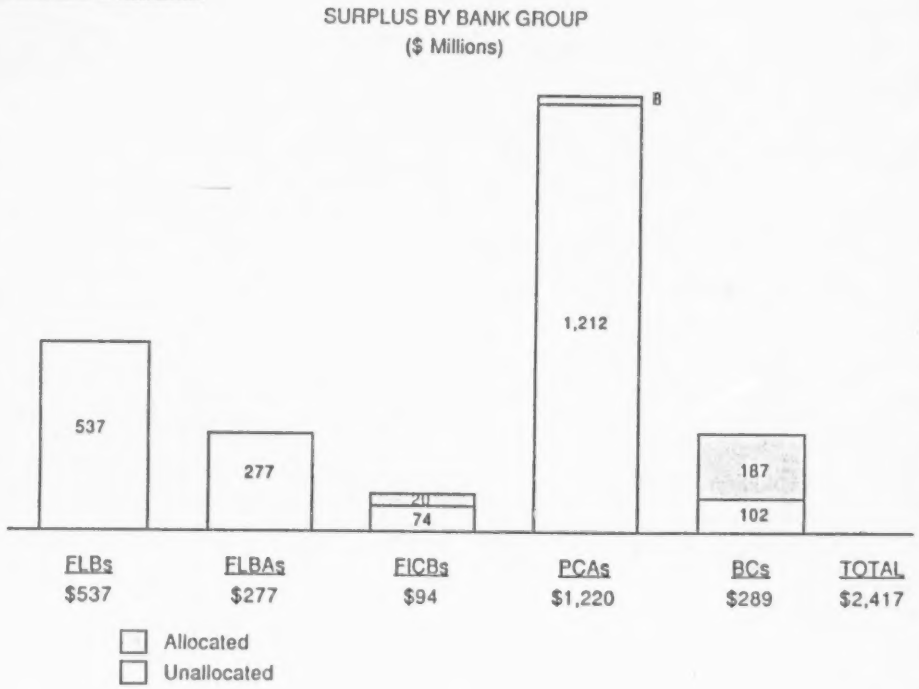
  - More importantly the surplus is now concentrated.

FINANCIAL CONDITION



- $1.2 billion of the $2.2 billion unallocated surplus at June 30, 1986 is contained in the PCAs - not directly accessible by capital preservation agreements and legal challenges are being made to the capital corporations ability to access his important pool of surplus.

FINANCIAL CONDITION



- Now, lets turn to projected financial data. Keep in mind the first comprehensive systemwide forecast was prepared a little less than a year ago. It was subsequently updated in March which we reviewed with you at the spring directors conference and again in August.

- The System's banks are getting better a making forecasts and this particular forecast is the best we have had but it is still a forecast based on what we know today and subject to:

  - Changes in the bank's assessment in loan quality as the banks gain better and better information on individual borrowers ability to repay;

  - changes in key factors affecting agricultural economy and hence the ability of our borrower to service their debt; and

  - changes in the commodities and interest rate markets.

- Further, this projection data has not yet been released to the public and I would ask ... plead ... that it be kept confidential.

FARM CREDIT SYSTEM

PROJECTED RESULTS OF OPERATIONS AND FINANCIAL CONDITION

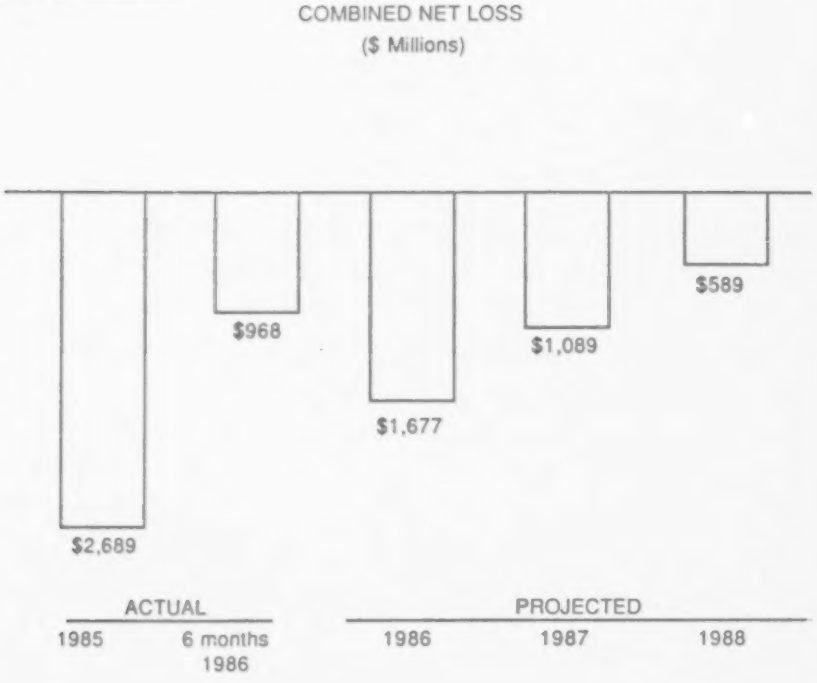
- Prepared by district managements as of August 1986

- Cover 1986, 1987 and 1988

- The banks project a combined net loss of nearly $1.7 billion for 1986. It could be higher but I doubt whether it will be much lower.

- More importantly, net losses are projected to continue in 1987 and 1988.

RESULTS OF OPERATIONS



- Provisions for loan losses are still the major factor in the net loss for 1986.

- However, it is important to note the significant slide of net interest income from 1985 to 1987.

- While net operating expenses are projected to be less than 70% of 1985 levels, net interest income significantly falls short of covering net operating expenses in 1987 and 1988. The primary lesson in this is that nonaccrual loans and acquired property yield little, if any, income and are very costly to service.

RESULTS OF OPERATIONS

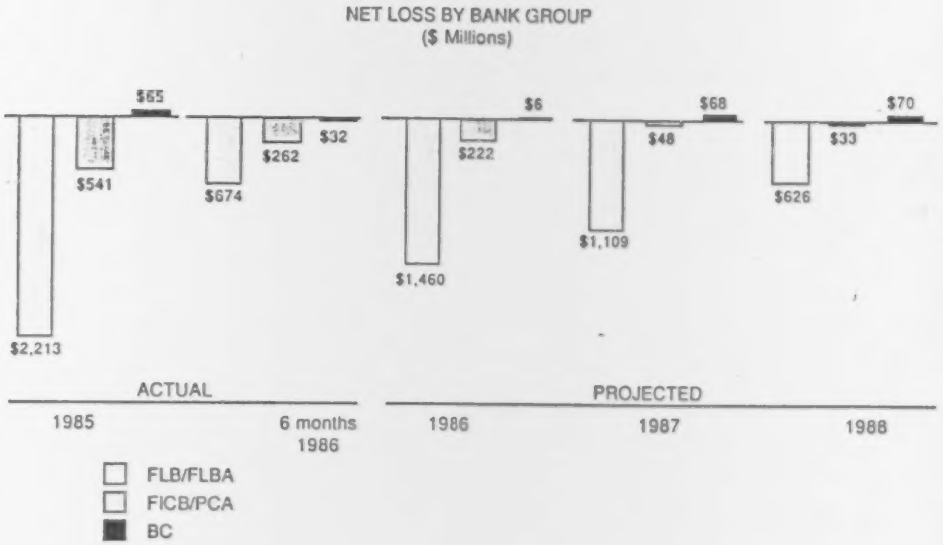
COMPONENTS OF NET LOSS
($ Millions)

	ACTUAL		PROJECTED		
	1985	6 Mos. 1986	1986	1987	1988
Net Interest Income	$1,295	$456	$ 738	$ 379	$385
Provision for Loan Losses	2,969	982	1,796	776	302
Net Operating Expenses	1,015	442	619	692	672
Net Loss	$2,689	$968	$1,677	$1,089	$589

- The bulk of the 1986 net loss, nearly $1.5 billion, is attributable to the Federal Land Banks.

- This pattern continues in 1987 and 1988 for the land banks, whereas the FICBs and BCs are projected to nearly break even.

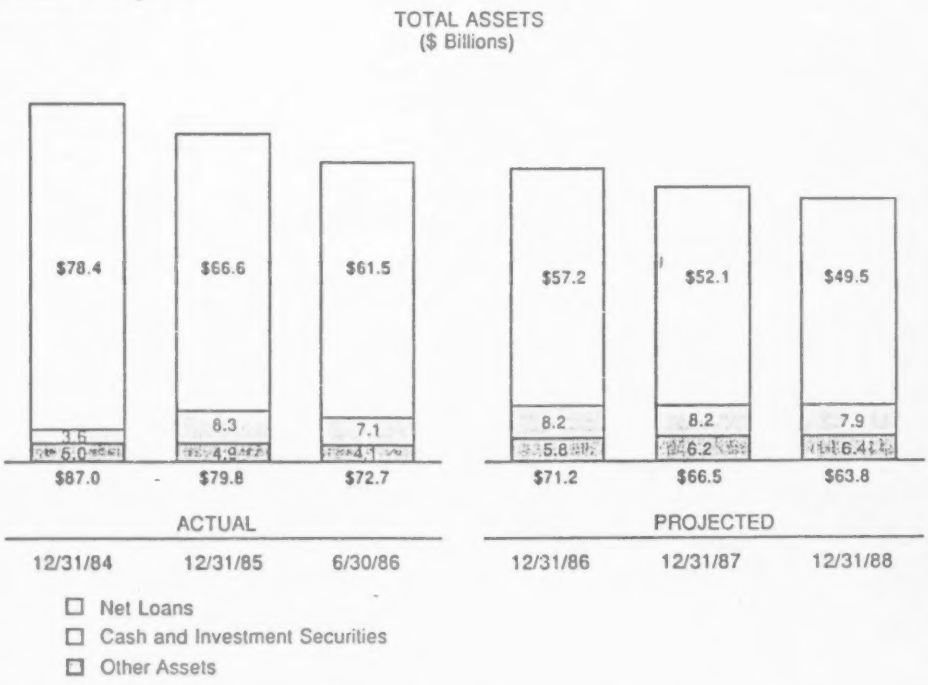
RESULTS OF OPERATIONS



- Total assets are projected to continue to decline to just over $60 billion at the end of 1988 when total loans would be less than $50 billion compared to nearly $80 billion at December 31, 1984. This realistically reflects shrinking agricultural debt market and loss of market share by FCS banks.

- Liquidity, cash and investments, necessarily remains high.

FINANCIAL CONDITION

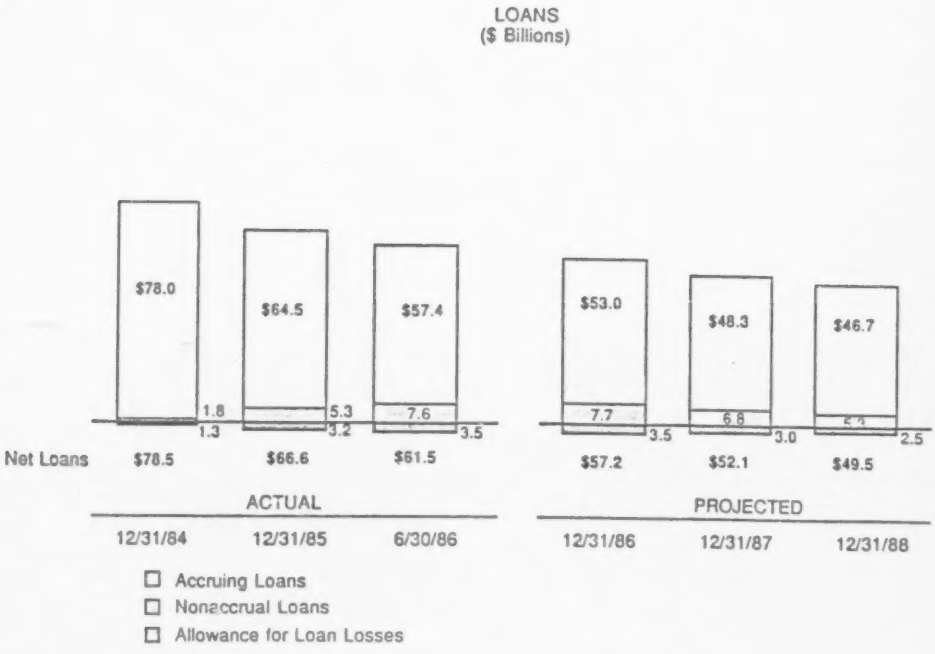


- This slide shows the dramatic actual and projected decline in accruing loans: From $78 billion at December 31, 1984 to $46 billion by the end of 1988.

- Interestingly, nonaccrual loans are projected to peak at December 31, 1986 at $7.7 billion - an important assumption to be proven or disproven by future actual events.

- Also, the level of the allowance for loan losses would peak at December 31, 1986 under these projections ... that is actual loan charge offs are expected to exceed additions to the allowance in 1987 and 1988 and we would begin to draw down the allowance.

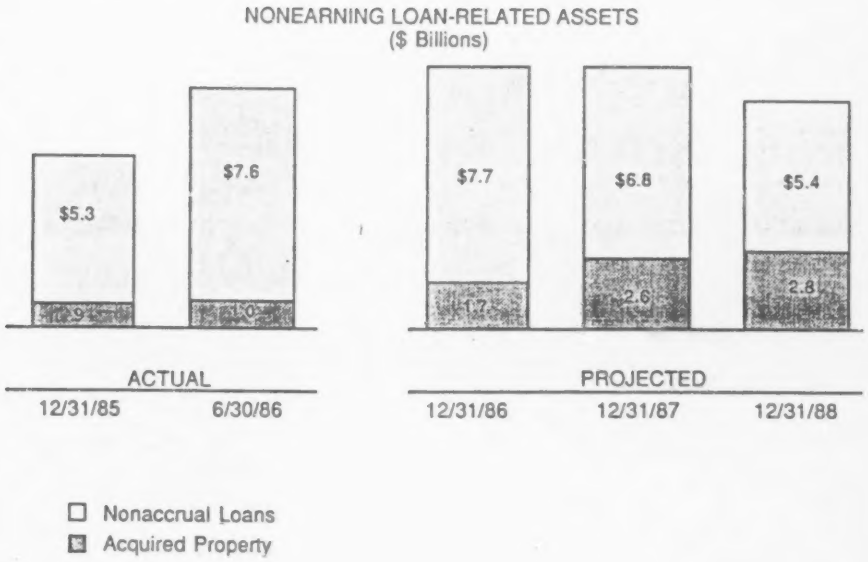
FINANCIAL CONDITION



- Important to note, however, it is expected that the overall level of nonaccrual loans and acquired property is still increasing in 1988 as foreclosures work through the System.

- Another Lesson: Nonearning assets grow faster than they disappear.

FINANCIAL CONDITION



- The allowance for loan losses in absolute volume and as a percentage of gross loans peak at December 31, 1986. Eventually the allowance for loan losses will return to a more normal level as the quality of the loan portfolio returns to a more normal level.

FINANCIAL CONDITION

ALLOWANCE FOR LOAN LOSSES
($ Millions)

	ACTUAL		PROJECTED		
	12/31/85	6/30/86	12/31/86	12/31/87	12/31/88
% Gross Loans	4.6%	5.3%	5.7%	5.5%	4.9%

The bottom line of the projection process is captured on the slide (i.e., at what point in time do we run out of surplus). In viewing this slide remember four things:

1. The allowance for loan losses cushions the impact on earnings and surplus of actual loan charge offs. To the extent potential loan losses are misjudged, and that is easy to do in his environment, earnings and surplus could be positively or negatively impacted.

2. Surplus is the cushion preventing loss of member capital.

3. Capital stock is the cushion preventing loss by investors in the FCS securities.

4. All of this is on a combined basis - in the interim many individual banks and associations impair capital. In other words, this assumes a perfect, harmonious world of sharing capital in a true cooperative spirit.

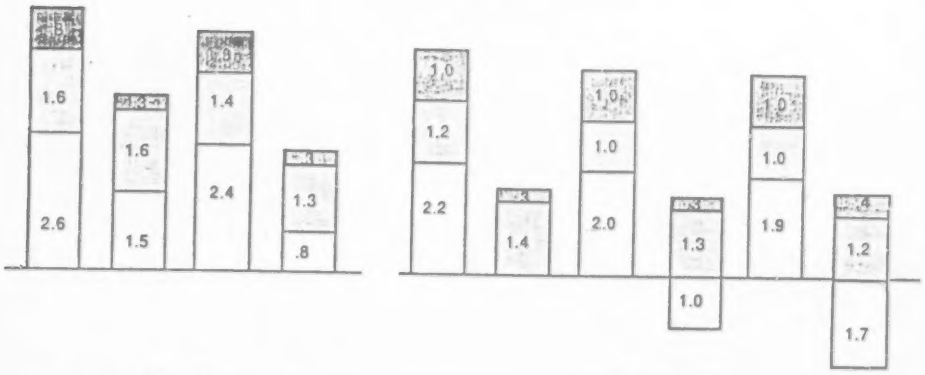
FINANCIAL CONDITION

- Finally, this slide shows the components of capital and surplus by bank group. Again we see that by the end of 1986 we are projected to have no surplus left in the Federal Land Banks and the bulk of surplus left will be at the PCA level.

- Absent a quick and favorable legal outcome to the challenges to capital corporation association assessment by the end of 1986, the System will have unallocated surplus of less than $200 million at the bank level.

FINANCIAL CONDITION

CAPITAL BY BANK GROUP
($ Billions)



ACTUAL				PROJECTED					
12/31/85		6/30/86		12/31/86		12/31/87		12/31/88	
Stock	Surplus	Stock	Surplus	Stock	Surplus	Stock	Surplus	Stock	Surplus
$5.0	$3.4	$4.6	$2.4	$4.4	$1.7	$4.0	$.6	$3.9	$(.1)

- BCs
- FICB/PCAs
- FLB/FLBAs

SUMMARY

- This is our System's best effort to forecast our near term financial future. I believe it is as realistic as we can be in the environment that we are currently operating.

- Our projections seem to suggest that 1987 will be the critical year for the Farm Credit System from a financial perspective and the events that unfold over the next few months can only marginally accelerate or delay that problem.

- Again, I caution you that the bulk of my presentation is projected data - future events and knowledge will significantly impact the actual results as they are reported.

- Obviously, the projection material is extremely confidential until such is formally released to the public which is expected to take place Wednesday following Brent Beesley's testimony to Congress.

FARM CREDIT SYSTEM
MODEL PRICING PROGRAM
MAY 6, 1986

"To retain market share and restore long-term profitability, the Farm Credit System will price its products and services on a locally competitive and differential basis considering risk and costs incurred." (Resolution #3 unanimously adopted by the FCS bank Chief Executive Officers on March 24, 1986, and the FCCA board of directors on April 2, 1986.)

To maintain and attract quality customers and successfully meet their credit needs, the Federal Land Banks and Federal Intermediate Credit Banks/Production Credit Associations should offer a reasonable selection of loan terms and rates which are priced on the basis of competition, risk incurred, and cost of servicing. This will require replacing the average cost of funds pricing strategy with marginal cost pricing strategy. In some districts, this will also require an expansion of the loan products and services offered.

This Model Pricing Program is designed to allow FCA to approve a single pricing program which, in the long term, will protect the capital of the FCS while giving the System maximum flexibility in responding to competitive factors and borrower needs. The Model Pricing Program is further designed to assure fairness between districts as pricing issues may impact the system's loss sharing arrangements. This Model Pricing Program does not define the upper limits which a bank or association may charge for its products.

1. Banks and associations will make available loan programs which offer:
   - A variable interest rate product.
   - A variety of fixed interest rate products (any loan which reprices less frequently than annually is considered fixed-rate).
   - Terms of up to 40 years.
   - Partially amortizing or fully amortizing payments.
   - Equal or decreasing payment plans.
   - Monthly, quarterly, semiannual, annual or single payment schedules.
2. Banks and associations should consider each of the following programs and implement some or all as deemed appropriate:
   - Loan origination fees.
   - Loan servicing fees.
   - Default interest rates and/or late charges.
   - Refinancing and/or conversion fees.
3. The lowest rate to be offered by FLBs and PCAs to Tier I borrowers shall be not less than 200 basis points over the bond equivalent yield on U.S. Treasury obligations of similar term to the repricing period of loan term offered, whichever is shorter. The margin for Tier II borrowers shall be not less than 300 basis points and Tier III shall be not less than 400 basis points. It is expected the average return of all differentially priced loans will approximate the Tier II range.

4. A greater margin may be charged if local competitive conditions allow or if special costs of delivery are incurred as each bank or association deems appropriate.
5. If interest is paid less frequently than monthly or if payments are not applied to interest first, rates charged should be increased to adjust the yield as required.
6. Variable-rate loans (including those currently offered by the FLBs) shall be priced off U.S. Treasury obligations with one year constant maturity based on the monthly report published by the Federal Reserve. Variable-rate loans should reprice at monthly, quarterly, semi-annually or annually.
7. To facilitate the transition from average cost pricing to marginal cost pricing and to protect earnings to the extent practicable, the variable-rate loan offered by FLBs shall not be below 9.0% for Tier I, 10.0% for Tier II and 11.0% for Tier III during 1986.
8. Differential pricing for variable- and fixed-rate loans should be implemented based on varying levels of credit risk, servicing costs, and size of loan. It is expected the average return of all differentially priced loans will approximate the Tier II range.
9. All borrowers will be assigned to one of the three tiers (districts may use more than three tiers). Initial tier assignments should be in Tier III unless current information is available supporting assignment to a higher tier. Upon receipt of current information, the initial tier assignment may be upgraded. Subsequent tier assignments will be reconsidered at the time of repricing.

Tier I--High quality loans with minimum servicing costs, all favorable credit factors and classified Acceptable. Evidence or strong earnings, repayment and management. May include quality large loans which represent relatively low per unit servicing cost.

Tier II--Average quality loans with average servicing costs, average earnings to service all debt and average credit factors although one or more significant credit weaknesses may be evident. Loan classified Acceptable although an occasional well secured Problem loan may be in this category.

Tier III--Below average quality with higher than average servicing cost, significant credit weaknesses including low equity ratio, frequent operating losses, numerous loan servicing actions, slow or inadequate repayment or inadequate security. Classified Problem or lower. May also include quality small loans which represent a relatively high per unit servicing cost.

10. As soon as practicable, all variable-rate loans will be funded by a pool of debt with the same weighted average maturity of the variable-rate loans outstanding.
11. Payments on variable-rate loans may be volatile as the interest-rate risk is transferred to the borrower. The loan analysis should include an examination of the borrower's ability to perform in a high interest-rate environment.
12. All other loans will be either match funded or handled under principles of asset/liability management such that there is minimal exposure to interest-rate risk.
13. Variable-rate and short-term loans of six months or less can be repaid at any time without penalty. Fixed-rate

loans may be prepaid only with a penalty (where allowed by law) sufficient to protect the lender from any loss.

14. Districts should establish a reliable market intelligence system to identify the major competitors such as commercial banks (by size), insurance companies and government agencies. Information gathered should be sufficient to determine the amount of share of each major competitor's business and the terms, conditions and interest rates for its products of services. Each district should establish a disciplined environment so that the information is accurate in content, timely in collection, consistent in format, analyzed for conclusions, and used by management in both pricing and marketing.

15. Banks adopting the Farm Credit System Model Pricing Program shall not revert to an average cost of funds pricing program or other pricing mechanisms without the approval of FCA.

FARM CREDIT SYSTEM GUIDELINES AND DEFINITIONS FOR RESTRUCTURING TROUBLED LOANS
May 6, 1986

General

The banks and associations of the Farm Credit System will administer troubled accounts with the objective of utilizing FmHA loan guarantees and other loan restructuring measures, including participation in federal- and state-funded interest rate buydown programs, as preferred alternatives to foreclosure.

Restructuring should be accomplished on a case by case basis when:

- The borrower has acted in good faith to manage his business affairs and has been cooperative with the banks or association;
- The borrower can present a plan with reasonable assumptions showing a high probability of return to financial viability as a result of the restructuring; and
- The alternative chosen will minimize any loss that will be borne by the other borrowers/stockholders of the bank or association.

(Resolution #7 unanimously adopted by the FCS bank Chief Executive Officers on March 24, 1986, and the FCCA Board of Directors on April, 2, 1986.)

The objective of these System Guidelines and Definitions for Restructuring Troubled Loans is to provide a reasonable alternative to foreclosure and property acquisition by:

1. Generating the greatest return of principal and interest to the FCS while protecting the interests of other stockholders.
2. Encouraging FCS participation in Federal and State programs which offer relief to financially stressed borrowers.
3. Standardizing key definitions which differentiate between normal forebearance and troubled debt restructuring and encouraging consistency in application.

Forebearance

Forebearance is the act of a creditor who refrains from enforcing contractual obligations, rights, or claims against borrowers when a debt falls due. Loan servicing actions such as rescheduling of principal and interest payments, change of installment dates, temporary forebearance of payments due, renewal of unpaid principal and interest, agreed carryover, waivers, subordinations, etc., are examples of forebearance. The common characteristic of this type of restructuring is that the lender receives all that was agreed to in the original contract. There is no special accounting treatment since no concessions are granted.

Forebearance shall continue to be offered on a case by case basis to assist worthy borrowers provided the borrower is:

1. Acting in good faith to manage and operate the agricultural business properly;
2. Applying the proceeds of production (minus reasonable and necessary living and operating expenses) to the payment of debt obligations;
3. Maintaining the buildings, improvements, and farm assets in a reasonable state of repair;
4. Working out of the existing situation and has the resources to operate the agricultural business efficiently.

Troubled debt restructuring

"A restructuring of debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court." (FASB 15)

The common characteristic is that the lender negotiates with the borrower and receives in return less than the lender had agreed to in the original loan contract. A Compromise of Indebtedness described in Section 4512 of the Regulations is a troubled debt restructuring. Troubled debt restructuring is subject to special accounting treatment as defined in Financial Accounting Standards #15.

Examples of loan servicing actions which constitute troubled debt restructuring are:

1. Transfer of real estate, receivables, or other assets to the lender to fully or partially satisfy a debt, including a transfer resulting from foreclosure or repossession.
2. Grant an equity interest to the lender to fully or partially satisfy a debt, unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.
3. Modify the terms of a debt by:
   - Reducing the stated interest rate for a period of years, up to the remaining original life of the debt.
   - Extending the maturity date at a stated interest rate lower than the current market rate.
   - Reducing the principal amount of the debt.
   - Reducing accrued interest.

Troubled debt restructuring is to be considered on a case by case basis. The analysis shall document the potential cost and

benefits of restructuring to the bank or association involved versus the loss which would likely occur using traditional methods of asset liquidation and foreclosure. Restructuring should be considered when the system will otherwise take a loss.

As a minimum the following factors are to be used:

1. The borrower is acting openly and in good faith, is caring for the collateral, has pledged or agrees to pledge all assets of reasonable value, has good farm management skills, and has a lifestyle adjusted to the current financial situation.
2. Complete and current balance sheets and income and expense statements will be obtained, analyzed and verified.
3. Complete and current appraisals and field reports should be made and analyzed. A projection of the lender's net realizable value of the collateral is to include expected movement of the market and the local level of stress.
4. A complete legal audit of the loan file is to be made to assure the sufficiency and accuracy of all loan documents.
5. The borrower is to present a workout plan and cash flow analysis using reasonable projections showing a high probability of orderly debt retirement as a result of the proposed restructuring.
6. Communication between all creditors is expected, especially the major long- and short-term lenders. Concessions from other creditors should be negotiated.
7. FmHA loan guarantees and interest rate buydown programs or any other Federal- or State-sponsored financial assistance programs should be utilized to the extent practicable.
8. The borrower should be advised to consult legal and tax counsel prior to finalizing troubled debt restructuring.
9. Normally principal should not be forgiven; it may be set aside on a deferred, reduced, or non-interest bearing note with a definite maturity.
10. Generally, the least cost alternative should be selected. While forebearance may be appropriate, debts that can clearly be collected through other means should not be restructured.

When restructuring troubled debt, certain operational issues should be addressed.

1. Troubled debt restructuring should be administered through one main focal point in each district. Districts are encouraged to establish a specialized loan restructuring unit to assist, coordinate, and control such cases. Prior to delegating restructuring authority to associations, districts should establish clear understanding and controls to realize consistent results.
2. Districts should develop a system to follow-up and supervise completed troubled debt restructuring actions to ascertain the case by case effectiveness.
3. Accounting treatment of all troubled debt restructuring shall be in accordance with Generally Accepted Accounting Principles.
4. Each district general counsel should review applicable state laws prior to implementation of these guidelines.
5. Nonaccrual loans shall be reviewed in accordance with Section 307 of the Farm Credit Act Amendments of 1985.

6. Periodic reports should be developed to provide the number and volume of loans and concessions granted according to each type of forebearance and troubled debt restructuring. The reporting data will be used to assess the overall effectiveness of these guidelines.

FARM CREDIT SYSTEM GUIDELINES AND DEFINITIONS
FOR
MANAGEMENT AND DISPOSITION OF ACQUIRED PROPERTY
May 6, 1986

The Farm Credit System owns substantial acquired property which represents the remaining assets after all efforts to administer forebearance and troubled debt restructuring have been made. The main objective is to convert the asset into one earning a market rate of return and promptly market the asset at the highest possible sale price. During the holding period, acquired property should be managed to maximize rental income, to balance the supply and demand for real estate in a local community to maintain a viable real estate market, and to reflect favorably on the Farm Credit System as a good steward of the land. Consistent with a marketing strategy, the best sale price considers the time value of money and results in the greatest net present value.

Turnover Period

The turnover period for acquired property is the amount of time elapsed between the receipt of marketable title to a property and the closing of a transaction to sell the property. Various state laws address the redemption period for foreclosed properties. Efforts should be made to market properties during the redemption period but care should be taken to provide for the eventuality that the property may be redeemed. State laws should be considered in this regard.

A system guideline setting the turnover period influences the pricing methodology for the property. Normally the less time agricultural property is exposed to the market, the lower the price required to move the property. However, the longer the system owns property, the longer the income stream will be negatively affected.

The average turnover period on acquired properties the banks or associations intend to sell should not exceed twelve months. A twelve-month turnover period allows the property to be exposed to the market during the time of the year when it will sell at the best advantage but limits the time of below normal earnings from owning the acquired property.

Financing Terms

Financing terms can be defined as those terms offered to a buyer that may facilitate the sale of the property. It includes credit worthiness standards, interest rate, down payment, amortization schedule, personal liability, loan origination fee, purchase of stock, etc. Seller financing terms offered to buyers of acquired property may be at the lower end of the competitive range. The competitive range is defined as a range of prices or terms that represent the current activities of those marketing a similar product in the same locale. Prices within this range reflect market rates; however, those at the lower end of this range will

have some competitive advantage. The goal should be to offer slightly better financing terms than other lenders or owners financing the sale of property without falling outside the competitive range. Credit worthiness can also be at the lower end of what is normally considered acceptable in routine lending activity, but the financing should still be considered sound. Terms of this type should allow a favorable selling price to be obtained consistent with a sale in the twelve-month turnover period.

The lower end of the competitive range allows slightly more favorable terms than normal Farm Credit System base rate financing. As a general rule a rate of at least 15 basis points above U.S. Treasury obligations of similar term will be considered within the competitive range for this purpose. Compliance with this guideline is expected to meet the GAAP requirement for financing to be considered consistent with prevailing interest rates as discussed in "Accounting Principles Board Opinion #21".

Property Pricing Methodology

Acquired properties should be priced so they will sell within the twelve-month turnover period taking into consideration the financing terms being offered. Offering prices should be carefully determined after studying all of the following factors:

1. Recent sale prices of comparable properties under both stress and nonstress conditions.
2. Projected rate of return using prices based on the study of comparable sales. Rate of return is calculated by dividing the net income by the appraised value or a proposed offering price.
3. Anticipated rate of return which potential buyers will demand to be encouraged to purchase the property within a twelve-month period -- given the real estate market and economic conditions in the area. This anticipated rate of return will consider the projected supply and demand and expected price movement of properties in the local area.

Appraised value of the property, based on comparable sales, does not always translate into the asking price for the property. If the real estate market is healthy, asking price and appraised value would normally be similar. If the real estate market is sluggish and in a declining trend, the asking price is based more on a subjective judgement of the rate of return it will take to encourage potential buyers to purchase than on the appraised value.

Good quality properties producing stable net income and a rate of return in excess of five-year U.S. Treasury obligations may be an exception to the twelve-month holding period. Such properties offer the potential of real-term price improvement. They should be priced at a higher level than might be called for in a twelve-month turnover period or indicated by a study of recent comparable sales.

Conditions of Sale

The Farm Credit Amendments Act of 1985 requires that if real property is acquired through foreclosure, the FCS shall not sell the surface rights to that real property to that person. Further, the Farm Credit Amendments Act of 1985 provides that sales of real estate that previously served as security for a loan in a

tract larger than a normal family size farm in the vicinity of the property cannot be sold for less than the amount it can receive from the Capital Corporation. Before selling such a large property, districts shall consult with the Capital Corporation and have documentation of the amount the Capital Corporation would pay to purchase the property.

Operational issues

1. Since the acquisition of property is a result of adverse action, it is important to consider the system's image while managing and disposing of acquired property. Employees should receive training and instruction describing how to accomplish their objectives to market acquired properties aggressively and at the same time enhance the system' image. Singular decisions made regarding lease, sale, purchase terms, etc., may be interpreted as systemwide policy and need to meet the test of reasonable business practices.

2. Acquired property management and sales should be administered through one main focal point in each district. Districts are encouraged to establish a specialized acquired property unit to assist, coordinate, and control this area. Districts should establish clear understanding and controls to realize consistent results where associations have delegated authority.

3. Each district should develop and maintain an information system that contains pertinent data on all acquired properties. This system is to provide management a means of asset control to determine if goals for acquired property management and sales are being met. The mechanism will be used to provide reports to the system to document progress in this area.

4. Inquiries to FCCA from parties interested in acquiring large or specific types of acquired properties will be coordinated with the district having properties that match such inquiries. A list of district persons in charge of acquired property will be maintained and distributed so a network facilitating intra-district acquired property sales can be enhanced.

FARM CREDIT CORPORATION OF AMERICA

MEMORANDUM

To: All Farm Credit System Bank and Service Entity Directors

All Farm Credit Bank and Service Entity CEOs/Presidents

From: H. Brent Beesley

Date: September 11, 1986

Subject: The Impact of Changes in Interest Rates on the Financial Forecasts for the FICB/PCA's and FLB/FLBA's for 1986-1988.

Attached are the financial forecasts for the FICB/PCA's and FLB/FLBA's for 1986-1988. The Base Forecasts were prepared by the twelve Districts and the CBC. Alternatives I, II, and III present various scenarios with respect to lowering the weighted average

interest rate charged on loans. Rates are lowered 50, 100, and 150 basis points in Alternatives I, II, and III, respectively.

We have assumed that as rates are lowered loan volume will increase over the base forecast and the level of problem assets and chargeoffs will decrease. Although it is impossible to prove the validity of these assumptions, we believe that they are reasonable business predictions based upon our perception of the current agricultural lending environment.

In each of the alternatives presented, net income declines in the forecast period. You will note, however, that reducing interest rates results in interest savings to existing borrowers that exceed the cost to the System. This is because of the increased loan volume and the reduction of troubled accounts offsets to some degree the reduction in the System's interest income.

In addition to the uncertainties surrounding the assumptions referred to above, it should also be understood that several uncontrollable factors may significantly impact System earnings and its provision for loan losses in any event. These include changes in general interest-rate levels, Federal farm programs, land values and commodity prices. These factors can change daily and are impossible to predict with accuracy. Anyone considering these forecasts should give due regard to these uncertainties.

[SEPTEMBER 11, 1986]

FLB'S/FLBA'S COMBINED FINANCIAL FORECAST

ALTERNATIVE 1

	Base Forecast			Adjusted Forecast		
	1986	1987	1988	1986	1987	1988
Avg. accruing loans	$38,283	$31,944	$29,547	$3,570	$33,221	$31,319
Avg. loan rate	11.70%	11.15%	11.06%	11.58%	10.65%	10.56%
Avg. debt	$43,651	$40,282	$38,779	$43,938	$41,039	$39,574
Avg. cost of Debt	10.76%	10.04%	9.61%	10.73%	9.98%	9.55%
Avg. nonearning assets	$4,601	$8,123	$7,746	$4,601	$7,636	$6,816
Allowance for losses	$2,642	$2,346	$1,928	$2,642	$2,343	$1,940
Earned net worth	$29	($1,081)	($1,703)	($4)	($1,161)	($1,781)
Net int. margin	$110	($160)	($152)	$77	($234)	($164)
Operating Expenses	$340	$351	$338	$340	$351	$338
Provision for losses	$1,532	$666	$223	$1,532	$639	$205
Net Earnings	($1,461)	($1,109)	($626)	($1,494)	($1,157)	($621)
Charge offs (net)	$1,157	$962	$641	$1,157	$938	$609
Net benefit to borrower				$48	$160	$148
Net benefit (cost) to system				($33)	($48)	$5

	Assumptive Factors		
	1986	1987	1988
Percent change loans	0.75%	4.00%	6.00%
Percent change chargeoffs	0.00%	-2.50%	-5.00%
Percent change provision for losses	0.00%	-4.00%	-8.00%
Precent change nonearning assets	0.00%	-6.00%	-12.00%
Cost of incremental debt	6.50%	6.50%	6.50%

ALTERNATIVE 2

	Base Forecast			Adjusted Forecast		
	1986	1987	1988	1986	1987	1988
Avg. accruing loans	$38,283	$31,944	$29,547	$38,570	$33,860	$32,501
Avg. loan rate	11.70%	11.15%	11.06%	11.45%	10.15%	10.06%
Avg. debt	$43,651	$40,202	$38,779	$43,938	$41,384	$40,181
Avg. cost of debt	10.76%	10.04%	9.61%	10.73%	9.95%	9.50%
Avg. nonearning assets	$4,601	$8,123	$7,746	$4,601	$7,392	$6,352
Allowance for losses	$2,642	$2,346	$1,928	$2,642	$2,342	$1,945
Earned net worth	$29	($1,081)	($1,703)	($54)	($1,321)	($2,010)
Net int. margin	$110	($160)	($152)	$27	($358)	($242)
Operating expenses	$340	$351	$338	$340	$351	$338
Provision for losses	$1,532	$666	$223	$1,532	$626	$196
Net earnings	($1,461)	($1,109)	($626)	($1,544)	($1,267)	($609)
Charge offs (net)	$1,157	$962	$641	$1,157	$926	$593
Net benefit to borrower				$96	$319	$295
Net benefit (cost) to system				($83)	($518)	($63)

	Assumptive Factors		
	1986	1987	1988
Percent change loans	0.75%	6.00%	10.00%
Percent change chargeoffs	0.00%	-3.75%	-7.50%
Percent change provision for losses	0.00%	-6.00%	-12.00%
Percent change nonearning assets	0.00%	-9.00%	-18.00%
Cost of incremental debt	6.50%	6.50%	6.50%

ALTERNATIVE 3

	Base Forecast			Adjusted Forecast		
	1986	1987	1988	1986	1987	1988
Avg. accruing loans	$38,283	$31,944	$29,547	$38,570	$34,499	$33,092
Avg. loan rate	11.70%	11.15%	11.06%	11.33%	9.65%	9.56%
Avg. debt	$43,651	$40,282	$38,779	$43,938	$41,731	$43,908
Avg. cost of debt	10.76%	10.04%	9.61%	10.73%	9.92%	9.25%
Avg. nonearning assets	$4,601	$8,123	$7,746	$4,601	$7,148	$9,605
Allowance for losses	$2,642	$2,346	$1,928	$2,642	$2,341	$1,951
Earned net worth	$29	($1,081)	($1,703)	($103)	($1,486)	($2,515)
Net int. margin	$110	($160)	($152)	($22)	($488)	($590)
Operating expenses	$340	$351	$338	$340	$351	$338
Provision for losses	$1,532	$666	$223	$1,532	$613	$187
Net earnings	($1,461)	($1,109)	($626)	($1,593)	($1,384)	($1,028)
Charge offs (net)	$1,157	$962	$641	$1,157	$914	$577
Net benefit to borrower				$144	$479	$443
Net benefit (cost) to system				($132)	($275)	($402)

	Assumptive Factors		
	1986	1987	1988
Percent change loans	0.75%	8.00%	12.00%
Percent change chargeoffs	0.00%	-5.00%	-10.00%
Percent change provision for losses	0.00%	-8.00%	-16.00%
Percent change nonearning assets	0.00%	-12.00%	-24.00%
Cost of incremental debt	6.50%	6.50%	6.50%

[September 11, 1986]

FICB'S/FCA'S COMBINED FINANCIAL FORECASTS

ALTERNATIVE 1

	Base Forecast			Adjusted Forecast		
	1986	1987	1988	1986	1987	1988
Avg. accruing loans	$12,447	$10,683	$10,067	$12,540	$11,110	$10,670
Avg. loan rate	11.06%	10.80%	10.48%	10.93%	10.30%	9.98%
Avg. debt	$12,581	$11,808	$11,099	$12,674	$12,210	$11,677
Avg. cost of debt	8.31%	7.98%	7.54%	8.29%	7.93%	7.49%
Avg. nonearning assets	$1,336	$1,226	$959	$1,336	$1,189	$901
Allowance for losses	$684	$560	$486	$684	$564	$495
Earned net worth	$1,354	$1,303	$1,268	$1,343	$1,263	$1,209
Net int. margin	$412	$389	$383	$460	$354	$355
Operating expenses	$412	$395	$385	$412	$395	$385
Provision for losses	$251	$97	$70	$251	$93	$64
Net earnings	($222)	($48)	($33)	($233)	($79)	($55)
Charge offs (net)	$365	$221	$145	$365	$212	$133
Net benefit to borrower				$16	$53	$50
Net benefit (cost) to system				($11)	($31)	($22)

	Assumptive Factors		
	1986	1987	1988
Percent change loans	0.75%	4.00%	6.00%
Percent change chargeoffs	0.00%	-4.00%	-8.00%
Percent change provision for losses	0.00%	-4.50%	-9.00%
Percent change nonearning assets	0.00%	-3.00%	-6.00%
Cost of incremental debt	6.50%	6.50%	6.50%

ALTERNATIVE 2

	Base Forecast			Adjusted Forecast		
	1986	1987	1988	1986	1987	1988
Avg. accruing loans	$12,447	$10,683	$10,067	$12,540	$11,751	$11,073
Avg. loan rate	11.06%	10.80%	10.48%	10.81%	9.80%	9.48%
Avg. debt	$12,581	$11,800	$11,099	$12,674	$12,766	$11,934
Avg. cost of debt	8.31%	7.98%	7.54%	8.29%	7.87%	7.47%
Avg. nonearning assets	$1,336	$1,226	$959	$1,336	$1,152	$844
Allowance for losses	$684	$560	$486	$684	$569	$505
Earned net worth	$1,354	$1,303	$1,268	$1,327	$1,223	$1,143
Net int. margin	$471	$389	$383	$444	$324	$323
Operating expenses	$412	$395	$385	$412	$395	$385
Provision for losses	$251	$97	$70	$251	$88	$57
Net earnings	($222)	($48)	($33)	($249)	($104)	($80)
Charge offs (net)	$365	$221	$145	$365	$203	$122
Net benefit to borrower				$31	$107	$101
Net benefit (cost) to system				($27)	($56)	($47)

	Assumptive Factors		
	1986	1987	1988
Percent change loans	0.75%	10.00%	10.00%
Percent change chargeoffs	0.00%	-8.00%	-16.00%
Percent change provision for losses	0.00%	-9.00%	-18.00%
Percent change nonearning assets	0.00%	-6.00%	-12.00%
Cost of incremental debt	6.50%	6.50%	6.50%

ALTERNATIVE 3

	Base Forecast			Adjusted Forecast		
	1986	1987	1988	1986	1987	1988
Avg. Accruing loans	$12,447	$10,683	$10,067	$12,540	$12,285	$11,576
Avg. loan rate	11.06%	10.80%	10.48%	10.69%	9.30%	8.98%
Avg. debt	$12,581	$11,808	$11,099	$12,674	$13,270	$12,361
Avg. cost of debt	8.31%	7.98%	7.54%	8.29%	7.82%	7.43%
Avg. nonearning assets	$1,336	$1,226	$959	$1,336	$1,128	$806
Allowance for losses	$684	$560	$486	$684	$570	$508
Earned net worth	$1,354	$1,303	1,268	$1,312	$1,169	$1,055
Net int. margin	$471	$389	$383	$429	$283	$285
Operating expenses	$412	$395	$385	$412	$395	$385
Provision for losses	$251	$97	$70	$251	$85	$53
Net earnings	($222)	($48)	($33)	($264)	($143)	($114)
Charge offs (net)	$365	$221	$145	$365	$199	$116
Net benefit to borrower				$47	$160	$151
Net benefit (cost) to system				($42)	($95)	($81)

	Assumptive Factors		
	1986	1987	1988
Percent change loans	0.75%	15.00%	15.00%
Percent change chargeoffs	0.00%	-10.00%	-20.00%
Percent change provision for losses	0.00%	-12.00%	-24.00%
Percent change nonearning assets	0.00%	-8.00%	-16.00%
Cost of incremental debt	6.50%	6.50%	6.50%

State of Minnesota,
Office of the Attorney General,
St. Paul, MN., September 18, 1986.

Honorable Jesse Helms
United States Senate
Senate Committee on Agriculture,
Nutrition and Forestry
328A Russell Senate Building
Washington, D.C. 20515

ATTENTION: Ron Phillips

Re: Hearings on the Farm Credit System Before the Senate Committee on Agriculture, Nutrition and Forestry

Dear Senator Helms:

This letter is submitted by the Attorneys General of Minnesota, Illinois, Iowa, Kansas, North Dakota and Wisconsin as our written statement to the committee in the above-referenced matter.

Almost one year ago we appeared before you urging Congress to couple any financial assistance to the Farm Credit System with statutory requirements that would assure consistent fairness in the System's dealings with its borrowers and shareholders. In response, Congress enacted Title III of the Farm Credit Act Amendments of 1985, making clear its intent to protect Farm Credit System borrowers' rights. Congress' response was deeply appreciated by FCS borrowers.

As you now hold hearings regarding the current status of the Farm Credit System and the Farm Credit Act Amendments, we feel impelled to comment again. You are well aware that the plight of the American Farmer is much the same as it was at this time last year. In fact, in most of our states, the farm economy has plunged into even deeper depression. While in some areas the Farm Credit System is cooperative, in others it is unnecessarily obstructionist.

First, the Farm Credit Administration has not yet promulgated final rules implementing Title III. Although the Amendments were enacted on December 23, 1985, and were effective on January 22, 1986, the FCA did not publish proposed regulations until May 8, 1986, and final rules are still unavailable. As a result, many of the complaints our offices were hearing regarding the System one year ago, we are still hearing today, and the reforms which we proposed are still gravely needed. There is imply no excuse for such delay by the FCA in this area which is so essential to the System's farmer-borrowers.

Second, the regulations proposed by the FCA are disappointing in several respects. We are particularly concerned with the provisions regarding credit review and forebearance. We believe that, if adopted as proposed, the regulations will have only a limited application and therefore will not result in the benefits which Congress intended. We submitted extensive comments on all of the proposed regulations and have attached those for your consideration. The FCA should be directed to modify the proposed regulations if they are truly to protect the rights of our nation's farmers as Congress intended.

Finally, the System has shown, at best, inconsistency in its level of cooperation with state efforts to address the desperate situation of many farmers. Iowa and North Dakota have experience some good results with System participation in Iowa's mandatory mediation program and North Dakota's debt restructuring program. However, in Minnesota, the System has brought a lawsuit in federal court challenging the constitutionality of major portions of the 1986 Minnesota farm bill, including mediation. The Minnesota bill was a carefully drafted effort designed to help Minnesota farmers in a time of great need. Moreover, the programs established by the bill are working: they are assisting farmers and rural business, including Farm Credit System institutions, to stabilize. The System has been repeatedly asked to work with us in developing and implementing State programs. Cooperation, not confrontation, is what will benefit the farm economy.

The original objective of Congress in establishing the Farm Credit System was to improve the well-being of American farmers. This objective needs to be preserved and supported today as never before. We therefore urge Congress to continue this session, as it did in the last, to insist that the Farm Credit System implement whatever reforms are necessary to treat their borrowers with fundamental fairness.

Very truly yours,

HUBERT H. HUMPHREY, III, Attorney General; NEIL F. HARTIGAN, Attorney General, State of Illinois; THOMAS J. MILLER, Attorney General, State of Iowa; ROBERT T. STEPHAN, Attorney General, State of Kansas; NICHOLAS SPAETH, Attorney General, State of North Dakota; BRONSON LaFOLLETTE, Attorney General, State of Wisconsin

Enclosure.

State of Minnesota,
Office of the Attorney General,
St. Paul, MN., June 5, 1986.

Chairman
Farm Credit Administration
1501 Farm Credit Drive
McLean, Virginia 22102-5090

Re: Regulations proposed at 51 Federal Register 17035

Dear Chairman:

We were pleased to see the publication of the proposed rules implementing the borrowers' rights provisions of the Farm Credit Act Amendments of 1985. On the whole, the regulations address many of the needs of Farm Credit System farmer-borrowers. In certain respects, however, the proposed regulations should be expanded or modified if they are truly to protect the rights of our nation's farmers as Congress intended. We therefore offer the following comments for your consideration.

Subpart 1--Liquidation of Associations

Obviously, the liquidation of an association is an occurence of major importance to the System's farmer-borrowers. As a result, borrowers should be personally notified when liquidation is to occur, and as Congress has required, steps should be taken which will minimize the adverse impact of liquidation on borrowers. Neither of these protections appear in the proposed regulations.

The only notification provision is contained in section 611.1160(c) which states:

> Upon the appointment of a receiver and acceptance by the receiver of the appointment, the Chairman shall immediately notify the institution and its supervisory bank and notice of the appointment shall be published in the Federal Register.

See also section 611.1170(d) (banks). This notice provision is inadequate in two respects. First, borrowers should be personally notified rather than notified through publication in the Federal Register. Few farmers have ready access to the Federal Register, and such notice is effectively no notice at all. Cf. Curry v. Block, 738 F. 2d 1556 (11th Cir. 1984). Second, borrowers should be notified as early as possible of pending liquidation so that they may prepare for the difficulty ahead. Certainly notice should be given prior to a receiver's accepting the appointment, and it should probably be given as soon as the decision to appoint a receiver is made.

Interestingly, the proposed regulations regarding the appointment of a conservator do provide for personal notice to borrowers. Section 611.1180(b). There is no reason why the appointment of a receiver should be handled differently. In fact, it is even more important for borrowers to be aware of a receivership with its impending liquidation. However, the notice regarding conservatorship is also given later than is desirable. Again, notice should be provided to the borrowers when the conservatorship decision is reached.

The proposed liquidation regulations are devoid of any attempt to minimize the adverse impact of liquidation on borrowers. In fact, the provisions regarding the sale and transfer of loans require the borrower to make immediately the required capital investment in the association which is purchasing his loan. Section 611.1165(b). This provision is contrary to the 1985 amendments in which Congress specifically required the System "to minimize the adverse effect of the liquidation on those borrowers whose loans are purchased by or otherwise transferred to another System institution." 12 U.S.C. S 2183(a) and (c). In its regulations, the FCA should direct institutions to implement this requirement by liberalizing financing in such circumstances, for example, by extending the time period in which stock purchases can be made.

The proposed regulations also permit the receiver to take any action he "considers appropriate or expedient to carry on the business of the association" during liquidation. Section 611.1161(b). This provision, which gives free rein to the receiver, is also inconsistent with Congress' requirement that the System minimize the adverse impact of liquidation on borrowers. Language should be added to the provision which will insure that the receiver does not violate borrowers' rights guaranteed by the

Farm Credit Act and the administration's regulations, and that the receiver minimizes the adverse impact of liquidation.

Subpart K--Disclosure of Loan Information

Proposed section 614.4367 sets forth the information regarding interest rates which institutions must disclose to borrowers. Paragraph (a) of that section requires the institutions to furnish such information "at or before" execution of the loan. The 1985 amendments require disclosure to be timely and meaningful. This requirement would be better met by directing the institutions to disclose interest information both at the time of loan application and execution. If the information is only provided at the time of execution, the borrower does not have the opportunity to adequately review the information and seek or negotiate alternatives.

Paragraph (a) also requires institutions to identify "the specific standard adjustment factors that are taken into account" in an adjustable rate loan. As we indicated in our letter of February 27, 1986, we believe that Congress has determined that System institutions should use and disclose a formula for variable rate loans. However, even if a formula is not mandated by the amendments more than a mere identification of factors is necessary to disclose adequately to borrowers the basis for adjustments in interest rates. We recommend that section 614.4367(a)(2)(ii) and Form 1 be modified to explain how the factors result in a change in the interest rate in order to better apprise borrowers of what they can expect.

Similar modifications are necessary in Section 614.4367(c) and (d) which require disclosure of information when interest rates are going to be adjusted. Paragraph (c) requires the institution to give a borrower ten days notice of a change in the interest rate. This notice period is inadequate. The borrower should be given 30 days notice in order to afford him an opportunity to explore other options if necessary. Paragraph (d) imposes the same requirement regarding changes in the effective interest rate and should also be amended to provide for a 30-day notice.

The explanation of the factors underlying changes in the interest rates under paragraphs (c) and (d) are also inadequate. Paragraph (c) merely requires the institution to state "any factors other than standard factors which were taken into account," and paragraph (d) fails to require any explanation at all. Both paragraphs should be amended to require a specific explanation of the basis for each change which occurs.

Finally, we recommend several additions to Form 1 regarding interest rate disclosure. First, following the explanation of the frequency and amount of changes in the interest rate, the form should state: "You will be notified at least 30 days in advance of any change in the interest rate." Second, as noted above, the standard adjustment factor should be explained, not merely listed. Third, following the sentence indicating whether the standard adjustment factors may be changed, a sentence should be added: "You will be notified at least 30 days in advance of any change in the standard adjustment factors." Finally, in the last paragraph of Form 1, the borrower should be urged to consult an attorney in addition to contacting the lender regarding questions.

Subpart L--Notice of Action and Review

In the 1985 amendments, Congress substantially expanded the System's requirements regarding right of review of adverse credit

decisions. The purpose of the amendments was clearly to increase the System's fairness in dealing with its borrowers. We strongly urge two modifications in this subpart if the regulations are to fulfill Congress' intent.

First, the right of review should be specifically made available to renewals or extensions of existing loans, particularly with respect to supplemental loan agreements which are common with the Production Credit Associations. Proposed section 614.4440(b) apparently excludes denial of such extensions from review. There is no basis in the 1985 amendments for excluding these renewals, and as a practical matter, they are the same as a new loan agreement, especially in their effect on the borrower. The borrower should therefore have the same rights which he would have if he were approaching the lender for the first time. As our February 27, 1986, letter indicates, we believe that review should also be available upon loan reduction, notice of acceleration, and denial of forebearance. However, at the very least it must be extended to a denial of loan renewal if Congress' mandate of fairness is to be met.

Second, section 614.4442 permits a board member who sits on a credit review committee to delegate his duties in certain circumstances. Although we appreciate that board members may have many responsibilities, clearly Congress intended one of those to be to sit on credit review committees. The purpose of requiring farmer board participation is to give the loan applicant an opportunity for input by a fellow farmer borrower. To allow board members to delegate this function defeats this important purpose. The language permitting delegation should therefore be deleted.

Subpart N--Loan Servicing Requirements

The proposed regulation regarding forebearance, section 614.4513, is particularly disappointing, and we urge that it be expanded in several significant respects. First, the FCA should direct System member institutions to make forebearance available. As a result, the language "should consider" in paragraph (a) should be amended to read "shall consider." Our experience is the many System institutions will not actively make forebearance available unless they are required to do so.

Second, paragraph (c), requiring district boards and the Capital Corporation to develop policies of forebearance, should also require the development of policies regarding default. This should include: (1) disclosure of events which may trigger default, including the grounds upon which the institution might deem itself insecure; and (2) the borrower's options upon default, such as application for forebearance. The regulations should also impose a deadline on System institutions for the development of policies regarding forebearance and default, for example, within 30 days of publication of the final regulation.

Third, the notice provisions, found at paragraph (d), are completely inadequate. Congress did not make explicit the notice required in the 1985 amendments. However, in similar circumstances, the Eleventh Circuit Court of Appeals required the Farmers Home Administration to provide notice of a borrower's forebearance options at four points: (1) at the outset of the loan term; (2) at the beginning of each production season; (3) when the borrower is notified that he is delinquent; and (4) when the borrower is given an acceleration notice. Curry v. Block, 738

F.2d 1556, 1562 (11th Cir. 1984). Curry is analogous for purposes of the notice requirement and should be followed by the FCA.

Finally, the regulation should be amended to include language which actively encourages forebearance by System institutions. As we noted in our February 27, 1986, letter, we are concerned that formal forebearance has rarely been used by the FCS. The 1985 third quarter report for all System institutions showed that the 12 Federal Land Banks had restructured or reduced rates on only four-tenths of one per cent of their high risk and nonaccrual loans. Similarly, the Production Credit Associations had restructured or reduced rates on only two per cent of such loans. Congress obviously intended to turn this situation around and to encourage the System to engage in forebearance. The House of Representatives recently reiterated this intention in House Concurrent Resolution No. 310, passed May 13, 1986. The AFC itself has publicly recognized the need for and benefits of forebearance, particularly debt restructuring. "Farm Credit System's Chief Regulator to Urge Restructuring of Loan Terms," Wall Street Journal (June 3, 1986). A policy urging forbearance should be made explicit in the rules implementing the 1985 amendments.

Subpart J--Prescription, Subscription, and Retirement of Stock

Section 615.5255(c) requires an institution to give only ten days notice prior to the retirement of stock when a borrower is in default. As with the other notice provisions addressed in this letter, the proposed regulation does not provide the borrower with an adequate opportunity to explore other options, and the regulation should be amended to increase the notice period to at least 30 days.

In sum, while the proposed regulations do much to implement the 1985 amendments, we urge you to adopt the above modifications to ensure that the protections enacted by Congress benefit the System's farmer borrowers as they were intended.

Very truly yours,

HUBERT H. HUMPHREY, III, Attorney General, State of Minnesota; NEIL F. HARTIGAN, Attorney General, State of Illinois; THOMAS J. MILLER, Attorney General, State of Iowa; ROBERT T. STEPHAN, Attorney General, State of Kansas; NICHOLAS SPAETH, Attorney General, State of North Dokota; BRONSON LaFOLLETTE, Attorney General, State of Wisconsin

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II

99TH CONGRESS
2D SESSION

S. 2770

To amend the Farm Credit Act of 1971 to provide the opportunity for competitive interest rates for the farmer, rancher, and cooperative borrowers of the Farm Credit System, and for other purposes.

IN THE SENATE OF THE UNITED STATES

AUGUST 15 (legislative day, AUGUST 11), 1986

Mr. COCHRAN (for himself, Mr. PRYOR, Mr. LEAHY, Mr. BUMPERS, Mr. FORD, Mr. BURDICK, Mr. MATTINGLY, Mr. ANDREWS, Mr. BOSCHWITZ, Mr. BENTSEN, Mr. DURENBERGER, Mr. HEFLIN, Mr. ABDNOR, Mr. DENTON, Mr. BOREN, Mr. STENNIS, and Mr. EAGLETON) introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

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A BILL

To amend the Farm Credit Act of 1971 to provide the opportunity for competitive interest rates for the farmer, rancher, and cooperative borrowers of the Farm Credit System, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Farm Credit System Borrower Interest Rate Relief Act of 1986".

SEC. 2. POLICY.

Section 1.1 of the Farm Credit Act of 1971 (12 U.S.C. 2001) is amended by adding at the end thereof the following new subsection:

"(c) It is declared to be the policy of Congress that the long-term credit needs of farmers, ranchers, and their cooperatives will be served if Farm Credit System institutions take appropriate steps to provide competitive interest rates for eligible borrowers based on the marginal cost of funds, taking into account the credit-worthiness of borrowers and the cost of servicing loans.".

SEC. 3. FARM CREDIT ADMINISTRATION APPROVAL OF INTEREST RATES CHARGED BY CERTAIN INSTITUTIONS.

(a) FEDERAL LAND BANKS.—The first sentence of section 1.7 of the Farm Credit Act of 1971 (12 U.S.C. 2015) is amended by striking out ", with the approval of the Farm Credit Administration as provided in section 4.17 of this Act".

(b) FEDERAL INTERMEDIATE CREDIT BANKS.—The second sentence of section 2.4 of such Act (12 U.S.C. 2075) is amended by striking out "with the approval of the Farm Credit Administration as provided in section 4.17 of this Act".

(c) BANKS FOR COOPERATIVES.—The first sentence of section 3.10(a) of such Act (12 U.S.C. 2131(a)) is amended

by striking out ", with the approval of the Farm Credit Administration as provided in section 4.17 of this Act".

SEC. 4. INTEREST RATES FOR BANKS AND ASSOCIATIONS WITH INADEQUATE CAPITAL.

The second sentence of section 4.3(b)(2)(A) of the Farm Credit Act of 1971 (12 U.S.C. 2154(b)(2)(A)) is amended by striking out "may not" and all that follows through the period and inserting in lieu thereof the following: "may not require the System institution to charge interest rates to eligible borrowers that exceed rates generally available to such borrowers from other commercial lenders, or require merger or consolidation, without a majority vote of the voting stockholders or the contributors to the guaranty fund of the institution.".

SEC. 5. DETERMINATION OF INTEREST RATES.

Section 4.17 of the Farm Credit Act of 1971 (12 U.S.C. 2205) is amended by striking out the first sentence and inserting in lieu thereof the following new sentences: "Interest rates on loans from institutions of the Farm Credit System shall not be subject to any interest rate limitation imposed by any State constitution or statute or other law. Such limitations are preempted for purposes of this Act.".

SEC. 6. FARM CREDIT ADMINISTRATION APPROVAL OF INTEREST RATES CHARGED ON DIRECT AND DISCOUNTED LOANS.

Section 5.17(a)(5)(A) of the Farm Credit Act of 1971 (12 U.S.C. 2252(a)(5)(A)) by striking out "and on loans made or discounted by such institutions".

SEC. 7. DEFINITION OF UNSAFE OR UNSOUND PRACTICE.

Section 5.35(4) of the Farm Credit Act of 1971 (12 U.S.C. 2271(4)) is amended by inserting before the period the following: ", except that such term shall not include the establishment of competitive interest rates based on the marginal cost of funds, taking into account the credit-worthiness of a borrower and the cost of servicing a loan".

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